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Residence in Tax Treaties

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To Cecilia, our children, and my parents.

Nihil volentibus arduum

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I would really appreciate any errors detected and comments on my work to be sent to my personal email jfranciscosepulveda@gmail.com.

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PART I

INTRODUCTION

1. Chapter 1 Introduction

1.1. Scope and purpose of this study

For more than half a century, the Organisation for Economic Cooperation and Development (OECD) has been leading the process of conceiving and developing a model instrument, capable of operating as a point of reference for States negotiating tax treaties. This instrument, the OECD's Model Tax Convention on Income and Capital (hereinafter referred to as the OECD MC or the Model), contains several provisions of a different nature. Most of these rules deal with the allocation of tax jurisdiction amongst the contracting States, in a manner of restricting the ability of those States to exercise their tax authority over a given person. In this sense, it is somewhat evident that the benefits contained in the Model are meant to be claimed by those who are subject to the tax authority of the contracting parties. Yet the OECD has been very precise in confining the subjective scope of its model treaty. Under Art.1 OECD MC, its rules apply only to *persons who are residents* of one or both of the Contracting States.

Bearing in mind this formula, in order to identify the cases in which a tax treaty becomes applicable, Art.4 OECD MC defines the term 'resident of a contracting State' in the following manner:

> '1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
>
> 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows.
>
>> a. he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
>> b. if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
>> c. if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
>> d. if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
>
> 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.'[1]

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[1] This is the updated version of Art.4 OECD Model Convention, proposed by the OECD in the context of the BEPS initiative in 2015. Under the 2014 version of the Model, Art.4(3) stated: 'Where by reason of the provisions of

If there is one remarkable feature of this provision, it is how flexible the definition enshrined in it is. A person, for instance, a tax-exempt pension fund or a charity, may be granted unrestricted access to a tax treaty by one State, whereas its counterparty may deny the benefits of the same treaty under the guise of that person not being 'liable to tax', and therefore not a 'resident' therein. The same reasoning applies to other potential treaty claimants, such as transparent entities, contractual arrangements, conduit companies, dual residents, residents of States applying the territorial system of taxation, amongst others. In all those cases, the existence of an actual tax liability under the rules of the Model may be hard to elucidate, and therefore their characterisation as residents becomes doubtful. In principle, the term 'resident of a contracting State' appears to set out the criteria for a decision on entitlement to the Model, and yet the ambiguity inherent to the rule prevents one from knowing, with a reasonable degree of certainty, the circumstances that justify the use of the benefits contained within. The flexibility of the definition is relevant for the purposes of many of the issues surrounding the application of tax treaties, although the reason for this is not entirely clear. However, if one considers that the term operates as the gateway to treaty benefits, it should not be striking that its ambiguity results in an interpretation of tax treaties that is, in general, highly controversial.

Accordingly, the purpose this study seeks is:

i. To identify and clarify the issues arising from the interpretation of the definition of residence in Art.4 OECD MC;
ii. To cast light on the interpretation of tax treaties by attributing its ordinary meaning to the term 'resident of a contracting State' in Art.4 OECD MC, in good faith, according to the general rule of interpretation under public international law; and
iii. To analyse and discuss the manner in which the definition of residence contributes to the determination of the object and purpose of the OECD MC, and to what extent this definition informs the meaning of abuse from a tax treaty perspective.

Bearing in mind the distinct nature of the issues and questions this study seeks to raise and confront, they may be organised into the following categories:

i. Issues derived from the definition of residence in Art.4 OECD MC as a legal term, including the attribution of its ordinary meaning to the term 'liable to tax' as an undefined treaty term. In particular, these issues include the presence of a definition of residence in the Model, its source, and the tax liability of pension funds, charities and tax-exempt entities in general, transparent entities, contractual arrangements, conduit companies, dual residents, and residents of States applying the territorial principle of taxation, amongst others.
ii. Policy issues in relation to the definition of residence and, in particular, related to the definition of treaty abuse from the perspective of the subject entitled to tax treaty benefits. These policy issues relate to the ability of Art.4 OECD MC to confront the issue of abuse from a treaty perspective, and therefore to its capacity to isolate from the scope of the Model certain treaty claimants, such as conduit companies, or persons carrying out schemes of treaty shopping, base erosion and profit shifting.

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paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated'. This modification was introduced as a result of the work of the OECD in the field of BEPS, see OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report*, (Paris: loose-leaf, October 2015), at p.72. The proposed changes to the Model, along with the old version of the rule, will be examined in detail in Chapter 12.

iii. Questions concerning the existence of residence in more than one State, and connected to the manner in which the OECD MC has dealt with this issue.

In the following paragraphs, the particular questions that are confronted across the length of this study are presented with the intention to introduce, in an orderly fashion, the individual issues it aims to clarify.

1.1.1. Issues connected to the definition of residence in Art.4 OECD MC as a legal term, including the attribution of its ordinary meaning to the term 'liable to tax'

The many issues derived from the definition of residence seem to suggest that there is little clarity as to how one must interpret the rule. This is somewhat expectable, if attention is paid to the text of the OECD MC and its Commentaries, and to the manner in which they have evolved. Throughout the Model many elements can be found which, directly or indirectly, deal with the attribution of its meaning to the term 'resident'. Furthermore, as the study of the history of the term demonstrates, there were several groups engaged in drafting different parts of the Model, which worked (in an often uncoordinated manner) to touch upon sensible aspects of the definition of residence. While the relevant Working Party at the OECD drafted the core of the definition[2], some crucial aspects of it were discussed by working groups in charge of the creation of other provisions of the Model[3]. In that context, any lack of clarity in relation to these elements, and even the fact that some of them appear to conflict amongst themselves when interpreting a tax treaty, should therefore not be striking. The following questions synthesise the main issues generated by the attribution of its meaning to the term 'resident of a contracting State' in Art.4 OECD MC, as a legal term.

a) Does the OECD MC define the term 'resident of a contracting State'?

Despite the fact that the question of whether Art.4 OECD MC defines the term 'resident of a contracting State' may appear to be too obvious, the presence of an actual *definition* of residence in the OECD MC may not be sustained beyond a doubt. Historically, the OEEC[4] held the view that, if there was only one State attempting to extend its tax authority on the basis of residence over one person, then the formulation of that concept at the treaty level was unnecessary[5]. Bearing this in mind, one may easily be led to believe that the Model does not really define residence, but it only sets out a redirection to the laws of the States dealing with residence, which is something that has been suggested in literature[6]. This view would be supported by the idea, expressed in the Commentaries, that the Model is not meant to create standards for domestic residents to access tax treaties[7].

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2 The study of residence (fiscal domicile) was originally assigned to Working Party 2, see FC/M(56)1(Prov.), at p.4

3 Debates were in fact held by Working Party 5, on the taxation of income and capital of shipping and air transport enterprises; Working Party 12, on the taxation of dividends; Working Party 14, on the personal and territorial scope of the convention; Working Party 15, on the methods for the avoidance of double taxation of income; and also at the Fiscal Committee, where the general aspects of treaties were discussed. All these considerations will be touched upon in subsequent parts of this study, at the point in which they become relevant.

4 The OEEC, 'Organisation for European Economic Cooperation', was the predecessor of the 'Organisation for Economic Cooperation and Development' (OECD), until 1961. Accordingly, all references made to the OEEC indicate events occurred before 1961, while references made to the OECD correspond to events that occurred during and after that year.

5 FC/WP2(56)1, at p.7.

6 Vogel, Klaus et al., *Klaus Vogel on Double Taxation Conventions*, Third Edition, (London: Kluwer Law International, 1997), n.99, at p.261.

7 Sec.4 of Comm. to Art.4 OECD Model Convention (2014).

However, one cannot ignore the fact that, to some extent, the definition of residence has been employed to exclude certain claims from the scope of tax treaties, because they seem undesirable or inappropriate[8]. By way of illustration, in 1992 and 2008 the OECD promoted an interpretation of the definition of residence according to which conduit companies and residents of States losing a tie-breaker were excluded from the scope of the Model. This is nonetheless something that clearly opposes the conviction that any domestic claim should be welcomed within the scope of the Model, which seems to be the idea behind the Commentaries when stating that no standards are imposed on the laws of the States dealing with residence. In a way, the main question of whether the Model defines residence seems to underpin the more fundamental question of whether the OECD MC contains a definition of residence that is diverse from that under the laws of the States, which is capable of setting out standards or boundaries for measuring the pertinence of a tax treaty claim. Arguably, the lack of clarity in relation to the former question prevents one from sustaining, with a fair degree of certainty, whether the possibility of rejecting domestic claims on the basis of the treaty definition, as it stands, is actually possible.

b) What is the source for a definition of the term 'liable to tax'? Does the term 'liable to tax', as an undefined treaty term, need to be defined under Art.3(2) OECD MC?

The interpretation of tax treaties involves a high risk of disagreement. Conflicts have in fact risen because, when interpreting a particular treaty, the contracting States may tend to observe the rules on tax treaty entitlement, and especially the definition of residence, from the perspective of their own laws. Under this logic, the same person may be considered to be a resident by one State, whereas its counterparty may not agree with this for a number of reasons. After all, the term 'liable to tax', at the core of the definition of residence, is an undefined expression, and it may thus be tempting to assume that the term must be assigned its meaning under the laws of the State applying the treaty, according to Art.3(2) OECD MC, unless the context otherwise requires[9].

The reference made to "that State" in Art.4 OECD MC, when singling out the laws under which the treaty claimant must be considered to be 'liable to tax', however, seems to point in a different direction. In fact, this reference suggests that the term 'resident' must be defined under the laws of the State of residence only. It is thus relatively evident that a question may be raised in relation to something as fundamental as the source from which the meaning of the term 'liable to tax' may be extracted and, perhaps more precisely, as to whether the term 'liable to tax', as an undefined treaty term, must be attributed its meaning according to the rule of Art.3(2) OECD MC, under the laws of the State *applying the treaty*.

c) What sort of persons may be considered to be 'liable to tax'? May bodies of persons, transparent entities or contractual arrangements be included within the subjective scope of the Model? Is the situation of the income treaty claimants receive relevant when ascertaining their tax liability?

As was stated earlier, according to the Commentaries, the Model is not meant to create nor impose any standards related to the characterisation of a person as a resident under domestic law.

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8 According to the OECD, the wording of the Commentaries "excludes from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income [and] also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, while being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States", see Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014). This rule will be explored extensively in subsequent parts of this work.

9 Art.3(2) OECD Model Convention (2014).

Furthermore, the definition of residence in Art.4 OECD MC refers, generically, to "any *person* who is liable to tax", therefore suggesting that tax liability is an attribute of persons. Bearing in mind that the definition of the term 'person' in Art.3 OECD MC is meant to promote the broadest possible subjective scope for the purposes of applying the Model, the question arises as to the feasibility of sustaining the tax treaty entitlement of transparent entities, bodies of persons, contractual arrangements and, in general, cases in which the identity of the treaty claimant is not very well defined. In very broad terms, while under the OECD MC it may not be harmful to consider these entities as 'persons', it is not clear whether they may also be considered to be 'liable to tax'.

The description of the term 'liable to tax', in the Commentaries, contains many sensible explanations in relation to the identification and characteristics of the treaty claimant. Some of these explanations, which refer for instance to cases of partnerships, seem to pose obstacles for fully transparent entities to be considered as treaty residents, raising the question of whether Art.4 OECD MC creates some sort of subjective threshold to access the Model. Moreover, bearing in mind that some courts have granted tax treaty entitlement in cases of transparency insofar as the relevant income is taxed in the hands of a resident (even if it is the partner and not the entity)[10], one may also wonder whether the situation of the income is of importance when attributing its meaning to the term 'liable to tax'[11], particularly in situations of transparency.

d) By reason of which factors must tax liability arise at the domestic level to cause tax liability to arise under the rules of the Model? Do the examples used in Art.4(1) OECD MC restrict the ability of other factors to generate treaty residence?

These questions refer to the fact that, by using certain examples (domicile, residence and place of management), the definition of residence in Art.4 OECD MC seems to conceptualise and restrict the criteria *by reason of* which residence at the treaty level may be established. Vogel, for instance, concluded that the factors mentioned in the definition of residence imply that a certain level of attachment (a locality-related one) is required for a domestic resident to access the Model[12]. In the *Crown Forest* case, the Supreme Court of Canada had to deal with the fact that the lower courts had determined that a company was a resident of the US under Art.4 of the US-Canada tax treaty, by reason of having a place of management and/or[13] a place of trade or business in the US, even though the company was, from a US domestic perspective, treated as a non-resident.

The definition in Art.4 OECD MC raises two fundamentally different questions in this regard. Firstly, by reason of what factors must one person be 'liable to tax' in a State in order to be granted access to the benefits of the Model; and secondly, following Vogel's reasoning, whether a qualified nexus (a locality-related one, for instance) may be required for the benefits of the OECD MC to be availed of on the basis of the criteria used in Art.4 OECD MC (and therefore if factors such as incorporation or nationality may be rejected). Generically speaking, the use of the

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10 Tax Court Canada, 08 April 2010, *TD Securities (USA) v. Her Majesty the Queen*, (2010) TCC 186; Income Tax Appellate Tribunal (ITAT) Mumbai, 16 July 2010, *Linklaters LLP UK v. ITO*, (2010) 95 DTC 5389 (ITAT Mumbai), Conseil d'Etat (Supreme Administrative Court) Paris, 13 October 1999, *Diebold* Case *191191*.

11 This question has been extensively discussed by Wheeler, Joanna, *The Missing Keystone of Income Tax Treaties*, (Amsterdam: IBFD, 2012).

12 Vogel, supra note 6, at p.233.

13 The Federal Court Trial Division accepted both arguments, whereas the Court of Appeal considered that Norsk was a resident in the US not because of having its place of management, but only as a consequence of being engaged in trade or business therein, see Supreme Court of Canada, *Her Majesty the Queen v. Crown Forest Industries Limited*, [1995] 2 SCR. For an analysis of the case see Ward, D., et al., 'A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries', in 44 *Canadian Tax Journal* 2 (1996), at pp.408-424.

expression 'by reason of', in Art.4 OECD MC, creates the need to discuss whether the particular connecting factors mentioned in the rule have consequences on the conceptualisation of tax liability, and thus on the definition of residence, for the purposes of the Model.

Further, this aspect of the definition is also relevant if one considers that, in addition to the criteria mentioned in the provision itself, there may be other elements which, being of a *similar nature*, are capable of giving rise to tax liability under the Model. By way of illustration, this may be the case of incorporation, nationality, or even source taxation, amongst other factors. Similarity in nature is, however, a notion that, under the description set out by the OECD, is rather unclear[14], and thus it may be prudent to make the effort of trying to find its meaning as well. Moreover, bearing in mind the need not to exclude residents from States applying the territorial system of taxation from the scope of the Model, expressly stated in the Commentaries[15], it may be fair to wonder whether territoriality may be considered within the criteria mentioned in the rule (or at least of a *similar nature*), for that would be the only way not to exclude these persons from the application of its rules.

e) How does the OECD MC define the relation of authority described by the use of the term 'liable to tax'? Does the definition of residence impose any conditions so as to specify the circumstances, moment, or extent to which the tax authority of a State must be extended over the treaty claimant for treaty residence to arise?

These questions refer specifically to the tax liability described in the first sentence of Art.4(1) OECD MC, and it considers the manner in which the Model has been drafted. Historically, the OECD introduced a distinction between a tax liability that was based on personal attributes (which was allegedly capable of triggering the application of the Model), and another one arising only in connection with the income a person was capable of generating. While only the former was meant to result in residence at the treaty level, this raises some interesting questions in relation to the term 'liable to tax' as a *relation of tax authority*, as described in the Model, and the conditions the Model seems to impose on that authority to be able to give rise to the application of its rules.

Firstly, authors commonly assume that the term 'liable to tax' refers exclusively to worldwide taxation[16]. However, the Commentaries to the Model explain that residents of States applying the territorial system of taxation should not be excluded from its application[17]. Secondly, in some cases the application of tax treaties has been discussed in scenarios in which a person is liable to tax in more than one State during the same taxable period, but not exactly at the same time[18]. The Commentaries to the Model refer to this situation as well. Thirdly, while it is clear that the liability required by Art.4 OECD MC to invoke the application of the Model is a liability *to tax*, it is not clear whether the rule refers to any taxes in particular. Lastly, while it is fairly evident that the State itself is not subject to its own tax authority, the Model nonetheless establishes its ability to claim

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14 Some authors have tried to restrict the possibilities of sustaining that criteria such as nationality or incorporation may be considered to be of similar nature, by arguing that a qualified connection between the treaty claimant and the State in which treaty benefits are claimed is necessary, see Vogel, supra note 6, at p.233; Widrig, Marcel, 'The expression "by reason of his domicile, residence, place of management…" as applied to companies', in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.286; and Jung, Marcel R., 'Trends and Developments in Swiss Anti-Treaty Shopping Legislation and Treaty Shopping Case Law', in 51 *European Taxation* 6 (2011), at p.233.

15 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).

16 Ward, supra note 13, at pp.412-413.

17 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).

18 United Kingdom, The Special Commissioners, 19 February 2008, *HRMC v. Smallwood*, at para.102.

tax treaty benefits. It is relatively clear that the OECD MC contains some guidelines to define the relation of authority portrayed by the term 'liable to tax', and the question therefore arises as to the precise nature of these considerations, and the manner in which they contribute to the attribution of its meaning to the term.

f) What is the meaning of 'comprehensive' tax liability? Does the second sentence of Art.4(1) OECD MC set out the meaning of tax liability for tax treaty purposes?

This question refers to the addition of a second sentence to Art.4(1) OECD MC[19]. The term 'comprehensive' tax liability, the significance of which is highly uncertain[20], is often presented as an effect of that addition. Bearing this in mind, one may be led to believe that the term 'comprehensive' is meant to set out the meaning of the term 'liable to tax' in a manner that is different to that in the first sentence of Art.4(1) OECD MC. This, however, is far from being certain.

The second sentence of Art.4(1) OECD MC, added to the Model in 1976, was supposed to deal with a very precise issue in the case of diplomats[21]. Allegedly, tax treaties interfered with the application of diplomatic tax benefits derived from other international instruments and therefore, only to avoid this, diplomats had to be left outside the scope of the OECD MC. However, further interpretations of the rule by the OECD seem to have amplified its scope significantly. The rule has been said to have a *spirit*, which is apparently capable of excluding, from the application of the Model, conduit companies and residents of States having lost a residence tie-breaker under Art.4(2) and 4(3) OECD MC[22]. One may naturally wonder whether it is in fact possible to stretch the interpretation of the rule in such a manner, bearing in mind the purpose of the rule itself, and the precise historical context in which it was added to the Model.

Moreover, one cannot ignore the fact that the new interpretation of the second sentence of Art.4(1) OECD MC, promoted by the OECD, has led to other interpretation issues. The OECD has had to explain, for instance, that the rule is not supposed to exclude residents of States applying the territorial principle of taxation from the scope of the Model. The question of whether this is possible under a reasonable interpretation of the OECD MC is nonetheless quite hard to confront, because the Commentaries are meant to exclude from its scope companies whose foreign income is tax-exempt (conduit companies). Arguably, the meaning of the expressions used by the OECD to define tax liability is misleading, and this hampers a coherent interpretation of tax treaties.

g) Does the authority of a State need to be exercised for tax liability to arise under Art.4 OECD MC? Is effective taxation required for the benefits of the Model to be granted under the definition of residence?

These questions refer mainly to the situation of pension funds, charities, and educational institutions, amongst other similar entities that are usually tax-exempt under the laws of many States. Arguably, there is little clarity as to whether these persons, in addition to being subject to the (latent) tax authority of a State, need to be subject to the exercise of that authority through the actual payment of taxes, to be considered as treaty residents. In quite straightforward terms, the question may be raised as to whether effective taxation operates as a condition for treaty benefits to be granted under the ordinary meaning of the term 'liable to tax'. This problem may be

[19] Under this rule, the term 'resident' "does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

[20] Couzin, Robert, *Corporate Residence and International Taxation*, (Amsterdam: IBFD, 2002), at pp.150-154.

[21] The first mention to this subject is found in 1958, see OEEC, FC/M(58)3, at p.10.

[22] Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).

confronted from the perspective of the State of source, where the benefits of the Model (namely the reduced rates of withholding tax) may be questioned if the income is not taxed in the State of residence, and also in the latter State, where the necessity of relief may be debatable if the relevant income were not taxed at source.

Some courts have attempted to counter the applicability of the Model in scenarios of non-taxation by attributing a certain meaning to the term 'liable to tax', which is in fact closer to the meaning of the word 'taxed'[23]. The fundamental question this interpretation raises, that is, the need to clarify whether this interpretation is feasible in the context of the OECD MC, is crucial if one considers the situation of pension funds, charities or educational institutions, amongst other tax-exempt entities. Despite the many reasons to sustain the convenience of their tax treaty entitlement from the perspective of policy considerations, the excessive narrowness of the definition of residence frustrates, in many instances, such an interpretation. The question of whether these entities may be entitled to treaty benefits is a question that, being confronted from the perspective of the meaning of the term 'liable to tax', is very much debatable.

h) How do the elements provided by the Model contribute to the attribution of its ordinary meaning to the term 'liable to tax' under the VCLT? How does the definition of residence contribute to the identification of the Model's object and purpose?

Regardless of all the above-mentioned issues and apprehensions, and despite the apparent inconsistencies at the core of Art.4 OECD MC, one must nevertheless confront the challenge of attributing its meaning to the term 'liable to tax', on which the application of tax treaties depends. However, the manner in which one is supposed to do so also raises an important number of questions. In principle, it is relevant to keep in mind that, under international law, there are rules for the interpretation of tax treaties, and those rules are crucial when unravelling the meaning of a treaty term. The Vienna Convention on the Law of Treaties (hereinafter "VCLT") sets out the basis, under public international law, for the attribution of its ordinary meaning to the term 'liable to tax', and therefore its rules must also be examined.

The manner in which these rules provide the ordinary meaning of the term has been, nonetheless, the object of debate, leading to additional issues in relation to the interpretation of treaties. How to build that meaning in good faith is, for instance, one of those fundamental questions, and to what extent must the intention of the parties be recognised when doing so, is another. Furthermore, one should not ignore the fact that the term 'liable to tax' has been used in a certain context, and therefore, when confronting the question of what the meaning of the expression is, the effects of having placed the term within that particular context must also be considered.

Moreover, one should also keep in mind that the expression forms part of a complex set of rules, which is meant to pursue certain objectives. To some, the object and purpose of the OECD MC is indeed a crucial element for the purposes of attributing a certain meaning to the expression 'liable to tax'. Those who think that the purpose of tax treaties is limited to the avoidance of double taxation, for instance, see no point in tolerating the application of the Model in cases of non-taxation. In these cases, the term 'liable to tax' is treated as a synonym of the term 'taxed'[24].

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[23] *Sportsman v. Inland Revenue Commissioners*, [1998] Simon's Tax Cases [Special Commissioners' Decisions], at para.6.9.

[24] See *Sportsman* case, supra note 23, at para.6.8. See also Italy, Tax Court of Turin, *case number 148/11/2010*. The case involved the application of the Germany-Italy tax treaty and the Parent-Subsidiary Directive. Dividends were distributed from a German subsidiary to its Italian parent. Considering that the Directive prevented any withholding tax to be levied in Germany, the court denied the exemption contained in the treaty.

Others, however, conceive tax treaties as mere instruments for the allocation of tax jurisdiction, and therefore conclude that effective taxation should not operate as a condition for treaty entitlement. Under this approach, the term 'liable to tax' is defined more precisely as 'liable to be liable to tax'[25]. Needless to say, under both approaches the term 'liable to tax' is interpreted in a dramatically different manner. However, the attribution of its meaning to the term 'liable to tax' in good faith, under the VCLT, seems to require the effort of harmonising the different elements provided by the OECD throughout the Model to explain the scope of the term, which is indeed a burdensome task.

Finally, the terms of a treaty should not be interpreted in the light of a preconceived idea as to its object and purpose. On the contrary, it appears that one should keep in mind the fact that even though the purpose of an agreement is meant to throw light on its terms, the particular expressions used to set it up must also be relevant to unravel the intention behind it. One must therefore also confront the question of whether the use of the term 'liable to tax' has an influence when unravelling the object and purpose behind an agreement such as the OECD MC, for this is a fundamental question that cannot be avoided.

1.1.2. Policy issues in relation to the definition of residence and, in particular, connected with the definition of abuse from the perspective of the subject entitled to tax treaty benefits

The fact that the OECD has attempted to deal with the issue of tax treaty abuse by attributing a meaning to the term 'liable to tax', that is to say, by interpreting the definition of residence in a certain manner[26], leads to the question of what the policy considerations are, at the core of Art.4 OECD MC, which allow the use of the rule for such purposes. Perhaps more fundamentally, the question may be raised as to whether the provision has the appropriate elements, from a policy point of view, to deal with the issue of the abuse of tax treaties.

i) What kind of policy considerations are involved in the definition of residence in the Model? Is the definition of residence relevant for the purposes of defining treaty abuse? How does the meaning of residence in Art.4 OECD MC inform the meaning of treaty abuse under the rules of the Model?

There are many policy considerations embedded in the definition of residence that are sensibly relevant for the purposes of deciding whether a treaty must be applied, or to decide whether a certain treaty claim is appropriate or not. The question of whether conduit companies must be granted the right to use the benefits of the Model, or whether these benefits must be tolerated under schemes of treaty shopping and profit shifting, are questions that have been historically confronted through the attribution of a certain meaning to the term 'liable to tax'. Yet the congruence of the definition of residence with these policy considerations, added to the Model at different points in time, is not self-evident. When tax treaties were first discussed, the policy objective the OECD pursued by establishing the definition of residence was the creation of the broadest possible subjective scope of application for its Model. Nowadays, however, the fundamental issues in the field of tax treaty entitlement are based on the exact opposite concern. Rather than securing a broad scope of application, it seems that the definition of residence leaves

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[25] Couzin, supra note 20, at p.107; according to Vogel treaties prevent not only current but also potential double taxation, see Vogel, supra note 6, n.46a, at p.28; Vogel, Klaus, 'Tax Treaty News', 53 *Bulletin for International Taxation* 3 (2005), at p.419; Supreme Court New Delhi, 07 October 2003, *Union of India and Another v. Azadi Bachao Andolan and another*, (2003) 184 CTR 450 (SC); Income Tax Appellate Tribunal (ITAT) Mumbai, 30 November 2005, *Green Emirate Shipping & Travels Ltd v. Assistant Director of Income Tax,* (2005) 11 TMI 239 (ITAT Mumbai).

[26] Sec.8-8.3 of Comm. to Art.4 OECD Model Convention (2014).

too much space for accessing treaty benefits and thus certain tax claims, which are questionable from a policy perspective (i.e. treaty shopping and profit shifting), cannot be left outside the scope of the Model without severe reservations. A few lines prior it was stated that the definition of residence was too narrow, because it was incapable of clearly including, within the scope of the Model, certain treaty claims that were desirable from a policy perspective. Paradoxically, one could also sustain that the definition is, in the exact same sense, too broad.

The renewed interest in the issue of tax treaty abuse resulting from the Base Erosion and Profit Shifting (BEPS) initiative certainly allows one to raise the question of what the function of the term 'resident' is, when defining the policy objectives behind an agreement such as the OECD MC. This question is seemingly relevant when addressing the issue of treaty abuse as well.

It is evident that there are certain expectations in relation to the definition of residence and the function that the rule is supposed to perform, or at least it appears to be so from the attempts made by the OECD to use the term to counter treaty abuse. As was stated earlier, in present times the question of whether one should be allowed to enjoy the benefits of a tax treaty, and under what conditions, is not as relevant as the question of who *should not* be able to do so. Yet this is not an issue that may easily be confronted from the perspective of the definition of residence as it stands today. For decades, the OECD has continuously added different adjectives to qualify the cases in which treaty benefits should not be availed of. Access to tax treaties has been described as 'improper', 'unintended' or, more recently, 'inappropriate', and 'unduly obtained'. However, the question of whether a conduit company may be considered to be 'liable to tax', for instance, does not seem to have been greatly clarified by these additions. While it is clear that certain treaty claims should be left outside the scope of the Model on the basis of reasonable policy expectations, the question of whether residence is appropriate to contend with an issue of this nature, from a policy perspective, is rather unclear.

One may be led to believe that the policy embedded in Art.4 OECD MC, together with the Model's object and purpose, aim in the direction of refusing certain tax treaty claims which are allegedly abusive. However, before simply stating this, an effort must be made to verify what the policy considerations at the core of the definition of residence truly are, and whether the rule is in fact capable of confronting the issue of abuse. In principle, absent any additional rules in the Model (such as a limitation-on-benefits provision or a general anti-abuse rule), under the approach followed by the OECD, the question of whether the use of a treaty by a conduit company may be qualified as abusive or not, must be examined by deciding if such company is 'liable to tax'. Whether this is reasonable or not on the basis of the Model itself, is quite a different story. The same may be said of the case of a person losing a tie-breaker. It is one thing to assume that the situation of such a person is abusive (which seems to be the path the OECD has decided to follow), and quite another thing to demonstrate that the situation is abusive on the basis of the manner in which residence has been defined (a much more difficult path). Under the OECD's approach, what the meaning of 'unintended treaty entitlement' is, seems to be a question intimately connected with the many dimensions of the term 'resident of a contracting State'.

j) BEPS and tax treaty residence: Did BEPS change the meaning of tax liability for treaty purposes?

The rise of the issue of BEPS in 2013 shifted the scope of the debate in relation to treaty abuse. In simple terms, measures have been proposed to avoid the granting of treaty benefits in circumstances that are allegedly inappropriate or abusive[27]. It is fairly evident that many measures proposed in the context of the project are aimed at restricting tax treaty access. However, it is rather unclear whether these measures are intrinsically connected with the provisions of the Model dealing with residence.

Amongst these measures, some modifications to the Model have been proposed in 2015 in order to include a general anti-abuse rule and a limitation-on-benefits provision. In general terms, these rules seek to require a stronger *nexus* between the treaty claimant and the State in which the treaty claim is raised, capable of justifying the applicability of the Model. In that context, it may be fair to wonder whether these additions have changed the context for the attribution of its meaning to the term 'liable to tax', redefining residence and tax treaty entitlement under Art.4 OECD MC. After all, tax liability is but the term used by the OECD to describe the heart of the connection a person must have with a given State to be able to claim the benefits of a tax treaty therein.

1.1.3. Questions derived from the potential existence of residence in more than one State, and with the manner in which the OECD MC has dealt with this conflict

k) How does Art.4 OECD MC deal with the situation of a person who is 'liable to tax' in more than one State? What is the effect of applying the residence tie-breaker?

Finally, the analysis of the term 'resident of a contracting State' would not be complete if attention were not paid to the fact that a person may maintain a tax liability in more than one State. The first question one needs to raise in this regard aims at identifying the manner in which Art.4 OECD MC solves that issue, to describe the mechanisms used to break ties, and to define the tests it employs to do so.

The purpose of the treaty tie-breaker is precisely to solve a conflict between two States of residence, giving preference to one claim over the other. Bearing that in mind, the manner in which the rule operates raises the question of whether its application may have an impact on the domestic qualification of such person as a resident. The OECD has tried to promote a certain interpretation of Art.4 OECD MC in order to explain the effect of applying the tie-breaker, lo leave persons having lost the tie-breaker outside the definition of residence. Yet it is unclear whether the rule itself is capable of supporting the production of such a fundamental result.

1.2. Structure of the research and methodology

The present study is divided into five parts. Part I has been presented as an introduction to the subject of residence in tax treaties, and primarily to the issues surrounding the rule of Art.4 OECD MC. By briefly describing these issues, the first part of this study has sought to discuss the relevance of the definition of residence for the purposes of the interpretation and application of tax treaties, setting out the basis for the detailed analysis of the terms contained in Art.4 OECD MC in subsequent sections of this work.

Part II is the heart of this study and examines the rule of residence in Art.4(1) OECD MC in detail. It delves, in principle, into the definition of residence as a legal concept. This section is mainly

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[27] See OECD, *Addressing Base Erosion and Profit Shifting*, (Paris: loose-leaf, February 2013); OECD, *Action Plan on Base Erosion and Profit Shifting*, (Paris: loose-leaf, July 2013); OECD, Public Discussion Draft, *BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances. Action 6: 2014 Deliverable*, (Paris, loose-leaf, March 2014); and OECD, Action 6: 2015 Final Report, supra note 1.

focused on attributing its ordinary meaning to the terms 'resident' and 'liable to tax', in the context of the Model, and in the light of its object and purpose. Needless to say, the analysis of the term 'liable to tax' as an undefined treaty term not only stands as the most extensive part of this study, but it also represents the foremost challenge of the present research. After having explained the rules describing the source from where the term needs to be defined, the study pays special attention to the manner in which the OECD has used the expression to portray a relationship of authority between a person and a State, and the particularities of this attachment. Further, subsequent chapters analyse the presence of certain elements in the OECD MC, which are allegedly meant to restrict access to its benefits. In particular, the study delves into the second sentence of Art.4(1) OECD MC, to analyse whether the introduction of this rule has imposed any conditions in relation to the manner in which the authority of a State needs to be extended over the treaty claimant. On the other hand, the question of whether this authority needs to be exercised for treaty entitlement to arise, and therefore the question of effective taxation as a requirement for treaty access under the definition of residence, is explored in a separate section. All the above-mentioned elements are thrown into the crucible and analysed in the light of the general rule of interpretation in the VCLT, seeking a coherent interpretation of the term 'liable to tax' in good faith. In particular, an effort will be made to explain the manner in which the definition of residence bears consequences for the purposes of identifying the object and purpose of the OECD MC. This section is dedicated to analysing the different parts of the definition of residence in Art.4 OECD MC, preparing the field for a subsequent examination of the policy considerations at the core of the rule, which is one of the main purposes of the present study.

Part III is focused on policy. By departing from the many policy considerations embedded by the OECD in the definition of residence, this section seeks to describe the role played by the rule of residence in judging the appropriateness of a tax treaty claim. More fundamentally, this part is aimed to explore the manner in which the set up of the term 'resident of a contracting State' has an influence on the definition of abuse for tax treaty purposes, and to discuss whether the rule is in fact apt to contend with this issue. Additionally, an effort will be made to analyse the effects of having added a general anti-abuse rule and a limitation-on-benefits provision to the Model on the interpretation of the term 'liable to tax', and thus on the matter of tax treaty entitlement, in relation to tax treaties containing these provisions.

Bearing in mind that the description of tax liability as a relation of authority by the OECD encompasses the situation of a person maintaining such a relation with more than one State, Part IV explores the issue of multiple residence in Art.4(2) and 4(3) OECD MC and its effects on the application of treaties. After exploring the dual residence conflict from an historical perspective, it analyses the solution stated by the OECD in its Model. Further, it delves into the analysis of the tiebreaker for individuals, looking for the ordinary meaning of the terms used in Art.4(2) OECD MC. In its last section, Part IV deals with the issue of multiple entity residence and explores the rule of Art.4(3) OECD MC in detail. For these purposes, it makes a distinction between the 2014 version of the rule and the updated entity tie-breaker proposed in the context of the BEPS initiative in 2015. This section mainly analyses the difficulties derived from the tiebreaker and its application.

Part V synthesises the conclusions arrived at throughout the present study in relation to the concept of residence in the OECD MC. Additionally, and where appropriate, it will offer some recommendations to be kept in mind when negotiating tax treaties.

In terms of methodology, in very broad terms, Part I and Part II are focused on the normative dimension of the definition of residence in the OECD MC. By discussing the history of the provision and the different expressions and phrases used in it, they seek to approach the meaning of the term itself, as used in tax treaties. The nature of the research process is one in which the different layers of the term 'resident' are singled out and discussed, with the purpose of reaching the heart of the provision, which is the policy behind it. This "peeling the onion's layers" method has therefore been chosen because it is particularly useful for the establishment of a clear background for the examination of the policy considerations at the heart of the rule, which is set out in Part III.

One of the main contributions of the present research is precisely connected with the methodology employed. On the one hand, the term ´resident´ is analysed as used in the OECD MC, and in the light of the instruments published by the OECD for its interpretation. While the value of the Model and its Commentaries for the purposes of interpreting tax treaties may be debatable, it is common practice to consider these elements when attempting to attribute its meaning to tax treaty terms in general. This approach, moreover, implies that the analysis contained in the present study may be of relevance for the interpretation of any tax treaty. On the other hand, the examination of all the different layers of the term ´resident´ results in a comprehensive analysis of the different aspects of the definition, which is also relevant for treaty interpretation purposes. Further, regardless of the value one attributes to historical documents from a tax treaty interpretation perspective (which in itself is a highly debatable subject), the history of the Model is repeatedly employed as an illustration of the context in which certain aspects of the rule were discussed. The profound attention paid to the history of the Model contributes to the understanding of some of the issues surrounding the rule, and to the policy considerations the drafters of the OECD MC had in mind and sought to embed therein. Perhaps the main contribution of the present research lies in the detailed discussion of the policy considerations behind the determination of the subject entitled to tax treaties, in times in which certain tax treaty claims have been labelled as *inappropriate*, and the recognition of treaty benefits as *unintended*.

All these different aspects are in line with the main purpose of this study, which is to contribute to the body of academic knowledge by setting out an instrument for the interpretation, and possibly the negotiation of tax treaties.

PART II

THE ORDINARY MEANING OF 'LIABLE TO TAX' AND THE MEANING OF RESIDENCE AS A LEGAL TERM IN ART.4 OF THE OECD MC

2. Chapter 2
A definition of residence in Art.4 OECD MC from an historical perspective

2.1. Introduction

On the face of it, many of the difficulties in applying Art.4 OECD MC arise from the lack of clarity as to whether the Model *defines* residence for treaty purposes. This question may appear to be too obvious, but it is nevertheless quite relevant for the purposes of interpreting tax treaties. On the one hand, one could follow the guidelines given by the OECD and assume that the rule's sole purpose is to materialise a redirection to the domestic laws dealing with the issue (after all, according to the Commentaries, the Model is not supposed to set out standards for domestic residents to be considered as treaty residents[28]). On the other hand, there are several reasons to believe that the many elements explaining the meaning of the term in the OECD MC are capable of setting out boundaries which, only after being trespassed, allow the treaty claimant to access the benefits of a tax treaty. The question of whether a conduit company, for instance, may be excluded from the scope of the Model, is answered in a very different manner depending on the position taken in relation to this problem.

From a policy perspective, this issue underpins the more fundamental question of whether the Model sets out a definition of residence that is different from that contained in the laws of the States, and whether this definition affects the conceptualisation of residence at the domestic level (so as to set out, for instance, parameters for measuring the pertinence of a tax treaty claim). Arguably, there is no certainty in relation to this. Regardless of the fact that these concerns were raised several times during the history of the provision, and that the OECD has attempted to resolve the issue of treaty abuse by promoting a specific interpretation of Art.4 OECD MC, the debate has not led to any precise outcome. In fact, when attempting to exclude a conduit company or a person having lost a tie-breaker from the scope of the OECD MC under the second sentence of the definition of residence[29], one cannot but wonder if this can actually be done. After all, as was stated earlier, Art.4 OECD MC seems to contain a mere reference to the laws of the States dealing with residence, and therefore it is these laws that, in principle, must determine the appropriateness of a tax treaty claim.

Throughout the years, it has been assumed that residence was a domestic issue, and that any residence-source conflicts were supposed to be solved on the basis of the laws of the alleged State of residence only. The history of the OECD MC, however, seems to point in a different direction. The OECD has been very careful not to affect the scope of attribution of the States at the domestic level (their national sovereign power) when defining who *should* be entitled to tax treaty benefits, while slightly changing the interpretation of the term resident in a way of imposing standards in this field. From the time the issue of treaty abuse was raised, in 1962[30], and nowadays under the influence of the BEPS initiative, the establishment of conditions for domestic residents to access

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28 Sec.4 of Comm. to Art.4 OECD Model Convention (2014).

29 Under Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).

30 See TFD/FC/136, *Note by the United States Delegation on tax avoidance through the improper use or abuse of tax conventions*, 04/01/1962. This note introduced for the first time the concept of 'improper' tax treaty entitlement.

the benefits of tax treaties is a major concern. Getting to know whether residence is in fact defined at the level of treaties, and not only as a domestic concern, is a fundamental piece of the debate.

2.2. The need for a definition of residence from an historical perspective

2.2.1. Introduction

In analysing the basis over which tax treaties were to be construed, one of the first aspects ever discussed at the international level was the need to define residence for the purposes of the Model. According to the OEEC[31], the answer to this question was given by the kind of double taxation the instrument was aimed at confronting, and the potential for double taxation was identified in two basic scenarios: Firstly, in the case of multiple tax claims based on the relationship between a person and certain States; and secondly, in the case of a person who, while being subject to a tax claim based on the existence of a personal attachment, was at the same time subject to another one, grounded only on the origin of the relevant income.

2.2.2. The dual residence conflict and the 'preference criterion'

The first situation is commonly referred to as *dual residence*[32]. At the time that the issue of tax treaty entitlement was first discussed, there was a trend towards extending the cases of tax claims based on personal attachment as much as possible. Certain States abandoned their strict legal concepts in order to include persons "often regarded as domiciled in the territory of the state irrespective of the fact that they have frequently been domiciled in a foreign state for years"[33]. According to the OECD, the likelihood of double taxation occurring in these cases was directly proportionate to the expansion of the circle of persons subject to the tax authority of each State.

The ever-expanding internal concept of residence of different States resulted in persons being considered as residents in more than one State. This generated the need for a rule capable of setting up boundaries to these domestic definitions, so as to prevent international conflicts. In this sense, it was assumed that a definition of residence in the treaty, capable of giving preference to one of the domestic tax claims, would settle any potential disputes. This 'preference criterion', implemented through the definition of residence and the tie-breaker contained in it, was therefore supposed to be instrumental for an election of one tax claim over the other.

2.2.3. The residence-source conflict and the 'guarantee criterion'

The need to solve the residence-source conflict, on the other hand, was based on the existence of a tendency to tax "economic activities […] irrespective of the existence of personal attachment"[34]. The States were broadening their rules of taxation to income arising within their jurisdiction, regardless of any connection between the person who received the income and that particular State. These rules evidently conflicted with the rules of residence. However, taking into consideration that the conflict involved the presence of only one tax claim based on a personal relation between a person and a State, the OEEC expressed:

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[31] The OEEC, 'Organisation for European Economic Cooperation', was the predecessor of the 'Organisation for Economic Cooperation and Development', OECD, until 1961. Accordingly, all references made to the OEEC indicate events occurred before 1961, while references made to the OECD correspond to events that occurred after that year.

[32] Sec.1 of Comm. to Art.4 OECD Model Convention (2014). The expression 'dual resident' has been criticised by van Raad, Kees, 'Dual Residence', 28 *European Taxation* 8 (1988), at p.241.

[33] FC/WP2(56)1, at p.1.

[34] FC/WP2(56)1, at p.5.

> "In the conflicts here discussed the renouncing state (the source of income state) will presumably not often make any test to ascertain if the circumstances provide reasons for considering that the taxpayer is domiciled in the other state, but will in reality be satisfied with the fact that the person concerned actually is considered to be fully liable to tax under the internal fiscal legislation of that state, and the criterion will thereupon, in this relation, in reality be a reference to the internal concept of domicile of the other State.
>
> This will often be completely satisfactory. When concluding a double taxation agreement, each of the states must be presumed to have made a mutual examination of the concept of domicile of the other state and found it satisfactory; for the rest a state will always have a possibility of terminating its tax renunciation by denunciation of the agreement."[35]

The solution agreed for the residence-source issue, in simple terms, considered that the rules of the State of residence provided enough guarantees that the problem would be solved. Therefore, bearing in mind that the Model was not supposed to set out a definition of residence in cases of residence-source conflicts, the Commentaries were structured so as to clarify that the Model was not supposed to create standards for the domestic laws of the States in order to give place to residence for tax treaty purposes:

> 'The conventions for the avoidance of double taxation do not concern themselves with testing the national rules of law of the Contracting States laying down the cases in which a person is to be treated fiscally as "domiciled" and, consequently, is "fully liable to taxation" in that State. The Conventions do not lay down standards which the national rules of law on "domicile" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the national legislations.'[36]

While the Model was meant to operate in cases of dual residence and residence-source conflicts, the definition of the term 'resident' was, in principle, restricted to conflicts of dual residence. In any other case, "for determining the taxpayers who come under the scope of the Agreement, a reference to the internal concept of domicile of the countries [was] found to be quite sufficient"[37]. Under the original construction of the rule of residence, as Vogel explained many years later, "if there is only one residence under the domestic law of one contracting State, then that residence is also the relevant treaty residence"[38].

2.2.4. A unique concept of residence for all tax treaty purposes

The history of the OECD MC clearly suggests that the intention to define residence from a treaty perspective was rather restricted. In the case of conflicts between residence and source, the lack of disagreement in relation to the meaning of residence made it unnecessary to elaborate such a concept. The absolute reliance on domestic definitions was evident in the first rule of entitlement to the Model ever drafted, which did not define residence at all[39].

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35 FC/WP2(56)1, at p.7.

36 This rule was added to the general part of the Commentaries and not in relation to the first paragraph of the provision proposed. This suggests that the statement refers to the residence-source conflict, for which standards were in fact not needed, see FC(58)2(1st Revision) Part II, at p.16. See also Sec.4 of Comm. to Art.4 OECD Model Convention (2014).

37 FC/WP2(57)1, at p.9. Furthermore, in such cases "the application of a particular and independent concept [was] superfluous and not very expedient", see at p.10.

38 Vogel, supra note 6, at p.261, n.99.

39 The first draft of a rule of entitlement to the agreement comprised three articles. Article 1 stated: "This agreement shall apply in every case where a person is fully liable to taxation in one of the Member countries", Article 2 dealt directly with the rules for solving a dual resident conflict, and Article 3 stated: "Where any person has a limited liability to taxation in a Member country in respect of income originating in that country, or in respect of capital therein, and is furthermore fully liable to taxation in another Member country, the right to tax shall belong to the

In the case of the dual residence conflict, however, things were not as clear. The Swiss Delegation highlighted the need for a precise concept of residence, capable of reconciling the divergences between the laws of the different States, on the basis of which the tie-breaker could efficiently be applied. In a way, some minimum standards were needed to decide which tax claim was to be preferred. Accordingly, the draft rule presented by it stated:

> "For the purposes of this Convention, an individual or a legal person shall be deemed to be domiciled in the State in which he or it is fully liable to taxation under the internal law, by reason of his or its domicile, head office or residence, or by reason of any other similar criterion"[40].

This rule, which has been identified as the most remote version of the current definition of residence in the Model[41], was nonetheless in principle ignored. Instead, the OECD turned its attention to discussing other subjects, such as the use of the term 'tax liability' or, more precisely, 'full tax liability'[42], only to conclude that most States were unacquainted with those expressions. These terms did not properly describe the different concepts used at the domestic level and therefore their use was regarded to be highly inconvenient[43].

Continuing with its focus on terminology, instead of 'full tax liability' the OECD decided to employ a more common expression, easily identifiable with the laws of the different States. Hence, the term 'resident' was used for the first time[44]. However, despite the fact that residence was supposed to replace the term 'liable to tax', instead of dropping the expression the OECD retained it to explain the meaning of residence. Coincidentally, this occurred at the precise moment in which the Fiscal Committee decided to use the rule proposed by the Delegation of Switzerland[45] so as to define residence for the purposes of the dual resident conflict only. All these different and concurrent decisions and proposals merged into a new rule that stated:

> 'For the purposes of this Convention, the expression "resident" of a State means any person who, under the national law of that State, is liable to taxation therein by reason of his domicile, residence, head office, nationality or some other similar personal criterion.'[46]

The rule was followed by a new paragraph:

> "Where under the provisions of the preceding paragraph a person is considered to be a resident of more than one State, this conflict shall be solved in accordance with the following rules".[47]

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latter country unless it is otherwise provided in the following Articles", see FC/WP2(57)1, at pp.2-3. The first definition of residence as conceived today appeared some time after, see TFD/FC/17.

40 See FC/WP2(57)2, at p.9, and the evaluation of the Fiscal Committee at p.2.

41 This proposal has been identified by Vann as the origin of the current version of Art.4 OECD MC, see Vann, Richard, '"Liable to Tax" and Company Residence under Tax Treaties', in Maisto, G. (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.226.

42 See FC/WP2(56)1, at p.1; and FC/M(57)2, at p.5. This was opposed to 'limited tax liability' that represented taxation of income from sources in a State regardless of any personal attachment.

43 FC/M(57)2, at pp.5-6.

44 FC/WP2(57)3, at pp.5-6.

45 There was some tension between the members of Working Party 2 and the Delegation of Switzerland which, incidentally, was not one of its members. The former was in fact of the opinion that the proposal introduced by the latter failed to define residence for treaty purposes, at least when compared with the definition that was originally proposed by Working Party 2. It is clear, however, that at this point the discussion was still focused on defining residence for the purposes of the tie-breaker only, see FC/WP2(57)2, at p.2.

46 TFD/FC/27, at p.1.

47 FC/M(58)I, at p.3.

It must be emphasised that this debate was held at a time at which the definition of residence was sought only to solve the dual residence conflict. The term 'resident', as defined in this first draft rule, was not supposed to entail a general definition for treaty purposes. In fact, the history of the rule combined with the wording of the provisions proposed, seems to suggest that the phrase "where under the provisions of the preceding paragraph"[48] was added precisely to stress the fact that the definition of Art.4 OECD MC was not a general definition of residence, but only one relevant for the purposes of applying the tie-breaker. Considering how emphatic the OECD was in its intention to leave the matter to the laws of the States in the case of a residence-source conflict, a unitary definition was not needed, except as a means to solve the dual residence problem. Hence, the definition of residence in Art.4 OECD MC was not, at least at this first stage, meant to operate in all cases, but only in circumstances of dual residence. The Commentaries to the original rule in fact stated:

> "The draft Article is intended *only* to solve the conflict between two domiciles"[49].

At a later point in time, however, this clear conviction faded away and was finally abandoned. The OEEC felt the need to frame all the national definitions through a unique concept of residence, applicable in all cases where the benefits of the convention were claimed. In order to materialise such a relevant measure, the OEEC did not modify the text of the Model, but only conducted the reform by introducing a slight change to the Commentaries. In fact, they were modified to state:

> "The Article is intended to define the meaning of the term "resident of a Contracting State" *and to solve cases of double residence*"[50].

In addition to this, once the drafting of the definition was completed, the OECD introduced a new rule to the Model expressly stating the need to verify the residence requirement in any case in which the benefits of a tax treaty were claimed. This rule, the current Art.1 OECD MC[51], which significantly expanded the relevance of the definition of residence for treaty purposes, was added some time after the term 'resident' had been defined under its current form[52].

The fact that the OECD steered away from the idea of not defining residence in the Model suggests that the definition of Art.4 OECD is not only meant to operate as a vehicle to materialise a simple redirection to the laws of the respective States. On the contrary, the definition of residence in the OECD MC, despite its very precise origin, was transformed into a generic one and, as such, it operates in every case in which treaty benefits are claimed. In other words, this implies that, when applying a tax treaty, one cannot ignore the terms of Art.4 OECD MC even if there is only one residence involved in the issue (residence-source conflict), and let alone in scenarios of dual

48 Currently, "Where by reasons of the provisions of paragraph 1", see Art.4(2) OECD Model Convention (2014).

49 Emphasis added. Similar to the current version of the Commentaries, the old version declared the relevance of the concept of residence in three cases: a) in determining the scope of application of the convention; b) in solving dual residence conflicts; and c) in solving conflicts between residence and source. The draft rule, under its original formulation, was expressly meant to deal only with the second objective, see FC(58)2(1st Revision) Part II, at p.16.

50 Emphasis added. Sec.2 of Comm. to Art.4 OECD Model Convention (2014).

51 Hattingh, Johann, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding It', 57 *Bulletin for International Taxation* 5 (2003), at pp.215-221; and Hattingh, Johann, 'The Role and Function of Article 1 of the OECD Model ', 57 *Bulletin for International Taxation* 11 (2003), at pp.546-553.

52 While the current version of Art.4 OECD MC was drafted in an almost definitive version by January 1958, the rule of Art.1 OECD MC appeared for the first time more than a year later, see FC/M(58)I; and FC/WP14(59)1, respectively. It is also relevant to notice that the first draft presented by Working Party 2 contained a rule substantially similar to the current Art.1 OECD MC stating: "This agreement shall apply in every case where a person is fully liable to taxation in one of the Member countries", see FC/WP2(57)1, at p.2. However, after consideration, the rule was dropped see FC/WP2(57)2, at p.1. The combined application of both articles, today, makes it clear that the definition of residence operates in any case the benefits of the convention are claimed.

residence. The definition of residence and the requirements imposed by it must be assessed in all cases. This conclusion is relevant inasmuch as there are many elements in the Commentaries, added during the first stage of the development of the definition, which suggest that the Model does not set standards for domestic residents to be considered as treaty residents[53], and that the issue of residence should be confronted from the perspective of domestic rules only. Insofar as these elements suggest this, they do not seem to belong there anymore[54].

2.3. Residence as defined 'for the purposes of this Convention'

The term 'resident' in Art.4 OECD MC is defined for all cases in which a tax convention must be applied and, in this sense, it is relatively clear that the definition at the treaty level and that under the laws of the States are two different and separate things. This of course raises the fundamental question as to how to deal with these two definitions and, more specifically, of whether the consideration of a person as a treaty resident entails any consequences when raising the same question from a domestic perspective. In fact, an argument may be raised that the presence of the expression 'for the purposes of *this* Convention' in Art.4 OECD MC circumvents the effects of treaty residence. The determination of treaty residence under such a premise would not affect the determination of residence at the domestic level[55]. If that is so, a person who is a resident of a State losing a tie-breaker, for instance, would not cease to be considered a resident of that State, contrary to what has been suggested by the OECD[56], the Supreme Court of the Netherlands[57] and eminent authors[58]. The definition of residence, at the outset, would operate 'for the purposes of this Convention' *only*[59]. The history of the OECD MC seems to suggest that this was precisely the underlying purpose behind the drafting of the rule.

Following the agreement adopted by Working Party 2 to define residence only for the purposes of the dual residence conflict, the Delegation of Switzerland sent some observations to the Fiscal Committee that resulted in being crucial for the final drafting of Art.4 OECD MC. They explain the circumstances under which the expression 'for the purposes of this convention' was added to the Model, and the effect that the application of the definition of residence was supposed to have. The document stated:

> "[t]he Fiscal Committee's discussions in June 1957 led to the conclusion that a definition of domicile was desirable only in the case where each of the two States claims that a person has his fiscal domicile in its

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53 Sec.4 of Comm. to Art.4 OECD Model Convention (2014). The fact that the Commentaries state that the Model does not set standards for domestic residence has in fact been found not to be entirely correct, see Vogel, supra note 6, at p.233; or 'plainly wrong', see Wheeler, supra note 11, at p.58.

54 This may be the reason why, at some point in the history of the Model, the Delegates of the Netherlands and Switzerland suggested that the first part of the Commentaries, drafted under the assumption that the definition of residence was fully domestic for residence-source conflicts, should be erased from the Commentaries, see FC/M(58)2, at p.5. Despite the validity of the observation, the OECD decided to reject it, see FC(58)2(1st Revision) Part II.

55 See van Raad, supra note 32; and van Raad, Kees, '2008 OECD Model: Operation and Effect of Article 4(1) in Dual Residence Issues under the Updated Commentary', in 63 *Bulletin for International Taxation* 5, (2009), at pp.187-190.

56 Sec. 8.2 of Comm. to Art.4 OECD Model Convention (2014).

57 The issue was put forward by The Netherlands Ministry of Finance, in a decision highly criticised by van Raad, see van Raad, Kees, 'Dual Residence and 1977 OECD Model Treaty Article 4(1), Second Sentence', in 30 *European Taxation* 1 (1990). The Hoge Raad of the Netherlands, considered this issue in its ruling of 28 February 2001, No.35.557, BNB 2001/295. See also Betten, R., 'Denial of Certificate of Residence to Dual Resident Company', 29 *European Taxation* 371, (1989); Smit, Pim, 'Netherlands. Treaty Residence of a Company in a Triangular Situation: Decision of the Supreme Court of 28 February 2001', in 42 *European Taxation* 4 (2002), at pp.155-158.

58 Sasseville, Jacques, 'A tax treaty perspective: special issues', in Maisto, G. (ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), at pp.42-48.

59 Vogel, supra note 6, n.98, at p.260-261.

> territory. All the delegations were opposed to the various internal provisions on domicile being replaced by a single generally applicable rule.
>
> All this is consistent with the traditional practice followed in Conventions for the avoidance of double taxation. Each State applies its own law insofar as it does not conflict with the provisions of a Convention. A Convention can only restrict the scope of the internal law, but it cannot supersede it. The same holds good for all the concepts employed in the rules as to attachment and in the definitions used in the Conventions. In practice, in order to determine whether a person has his domicile in a State, it is necessary first of all to refer to the internal law. If this results in a conflict with the law of another State, then the provisions of the Convention binding the two countries concerned must be applied. There is certainly no justification for modifying this practice. […]
>
> In its report and draft Article, the Working Party has not restricted itself to defining the concept of domicile or of full liability to taxation but has further proposed the solution of a number of cases of double taxation. In so doing it has taken an entirely new course in Conventions against double taxation.
>
> Such Conventions apportion between the two contracting States in accordance with certain criteria (known as criteria of attachment, such as domicile, location, place of employment, source), the right to tax the different items attracting tax, which can be either an exclusive right to tax, or merely a preference right in the sense that one of the States must set off against its own taxes levied in the other State. The attachment criterion in many cases must be precisely defined, so that there can be no dispute over the taxing jurisdiction. Such a definition is necessary in the case of domicile in particular. *But the clause which defines domicile has only an accessory function. Its purpose is not even to resolve a double taxation conflict, but merely to determine which of the two contracting States is entitled, as the domicile State under the Convention, to tax a particular object of taxation allotted by the Convention to the jurisdiction of the domicile State*.
>
> The Article II proposed by the Working Party goes much further. If two States simultaneously consider a person to be fully liable to tax in their territories, it confers on one of them the exclusive right to tax all objects of taxation. *Normally, there should be no conferring of taxing powers except with respect to those objects which alone, according to the Convention, are taxable in the taxpayer's State of domicile*"[60].

The observations made by the Swiss Delegation aimed at challenging the broad consequences attached to the determination of residence that resulted from the dual residence conflict suggested in the draft proposed by Working Party 2. Under the OECD's original proposal[61], the State in favour of which the tie-breaker was solved was granted the right to tax all elements of income received by the respective person[62]. This was perceived as a creation of permanent rights in favour of that State. Contrary to this approach, and bearing in mind the need to restrict the effects of the rule only to those objects of income in relation to which treaty benefits were claimed, the proposal of the Swiss Delegation stated:

> "*For the purposes of this Convention*, an individual or a legal person shall be deemed to be domiciled in the State in which he or it is fully liable to taxation under the internal law, by reason of his or its domicile, head office or residence, or by reason of any other similar criterion"[63].

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60 Emphasis added, see FC/WP2(57)2, at pp.4-6.

61 Art.II of the original OEEC proposal stated: "Where a person is fully liable to taxation in more than one Member country, the right to tax shall belong: […]". Art.III in turn stated: "Where any person has a limited liability to taxation in a Member country in respect of income originating in that country, or in respect of capital therein, and is furthermore fully liable to taxation in another Member country, the right to tax shall belong to the latter country unless it is otherwise provided by the following Articles", see FC/WP2(57)1, at pp.2-3.

62 Given the approach followed by the OECD, it is assumed that a similar opposition would have followed the interpretation of Art.4 OECD MC introduced to the Commentaries in 2008, as it intends to create permanent rights in favour of one of the contracting States. The new interpretation apparently creates permanent effects for the qualification of residence not only under the domestic law of the respective State but also and consequently for the purposes of the application of other treaties. That subject is explored in detail in Chapters 7 and 12.

63 FC/WP2(57)2, Annex 2, at p.9.

Regardless of the initial opposition of Working Party 2 to follow such drafting[64], the Fiscal Committee adopted, in essence, the rule proposed by the Swiss Delegation[65]. That rule was put in place as the official definition of residence for the purposes of Working Party 2[66]. Under that wording, the definition was included in Art.4 of the 1963's Draft Convention[67].

Considering that this was the first time that the expression was used, the history of the Model suggests that the phrase 'for the purposes of this Convention' was added to highlight the restricted effect of the treaty definition of residence. The function of the term was confined only to the allocation of taxing rights in respect of certain elements of income under the tax jurisdiction of the State of residence, and not to the recognition of the perpetual and unconditional right to tax the person in favour of that State. The inclusion of the rule in those terms suggests that the definition of residence for treaty purposes could not have been intended to bear any decisive consequences for the purposes of residence at the domestic level[68].

Furthermore, eighteen years later, the issue of dual residence was re-examined in the context of the methods of relief. Working Party 1 used the example of a person, resident in States A and B, receiving income from immovable property situated in State S. Assuming State A having won the tie-breaker, the possibility of preventing State B from taxing such income as part of the person's worldwide income was explored. The issue was, in plain terms, that "the other State [State B] is not expressly precluded from taxing a person who under its internal law is subjected to unlimited tax liability but for the purposes of Article 4 of the Convention is not a resident of such State"[69]. Two solutions were proposed to solve this problem:

> '6. One solution would be to state in Article 21 or 23A or 23B quite generally that the income derived or capital owned by a resident of a Contracting State shall be exempt from tax in the other Contracting State, except where another Article of the Convention expressly provides for taxation of such capital or income in the State which is not the State of residence. *The same goal could be achieved by inserting in paragraph 1 of Article 4 after "For the purposes of this Convention" the words: "and the internal law of the Contracting States"*.'[70]

All this evidence suggests that the definition of residence was not meant to cause an effect on the configuration of domestic residence. On the contrary, Working Party 1 was of the opinion that, irrespective of a possible interpretation of the rule in this sense, it was advisable to include such a rule in the text of the provision. This would indicate that the effects of Art.4 OECD MC were restricted to the sphere of the Model, and that any interpretation extending the effects of the rule to the domestic laws of the contracting States had to be sustained on the basis of those laws.

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64 Working Party 2 in fact disregarded the suggestion and insisted on proposing a rule under a wording that was nonetheless similar to the rule that gave place to the Swiss observations: "Where any person has a limited liability to taxation in a Member country in respect of income originating in that country or in respect of capital therein and is furthermore under the law of some other Member country fully liable to taxation in that other country by reason of his domicile, residence, head office, nationality or some other similar criterion, the right to tax shall belong to the latter country unless it is otherwise provided in the following Articles", FC/WP2(57)2, Annex 3, at p.11. However, at the subsequent meeting the original draft was abandoned and replaced by a rule closer to the Swiss proposal: 'In the present Convention, unless the context otherwise requires: The term "resident" of a State means any person who, under the national laws of that State, is subject to tax in that State as a resident', FC/WP2(57)3, Annex, at p.11.

65 The rule approved by the Fiscal Committee stated: 'For the purposes of this Convention, the expression "resident" of a State means any person who, under the national law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other similar criterion', see FC/M(58)I, at p.3.

66 FC/WP2(58)1, at p.2.

67 C(63)87 Part I, at p.40.

68 Vogel, supra note 6, n.31a, at p.234, and n.98-99, at pp.260-261.

69 CFA/WP1(75)5, at p.2.

70 Emphasis added. CFA/WP1(75)5, at pp2-3.

Treaty residence, after all, was considered a matter of the exclusive dominion of the domestic laws of the relevant States.

2.4. Domestic residence as treaty residence

2.4.1. Defining treaty residence solely on the basis of domestic law

While discussing if the term ‘resident’ had to be used only in dual residence scenarios or in all circumstances, the OECD identified some cases in which the presence of only one domestic definition of residence was not enough of a factor to settle a dispute between two States[71]. Accordingly, the question was raised as to whether it was:

> “[...] reasonable and natural that a country of source of income – which by agreement has waived taxation [...] – must in all circumstances accept that the right to tax should belong to the country in which the person concerned is fully liable to tax, so that the internal concept of domicile of the latter country is alone decisive.”[72]

The sacrifice made by the State of source was considered to be too significant to be unconditionally subject to the laws of the State of residence, since those laws at the same time were increasingly expanding the scope of the subject entitled. Following the guidance provided by the Four Economists[73], the possibility of imposing some minimum standards for domestic residence in order to give place to residence in the context of treaties was examined. Three aspects were analysed which, despite the many years that have passed, may easily be identified with the current concerns in the area of tax treaty abuse and double non-taxation.

Firstly, the presence of effective taxation in the State of residence was examined as a possible condition for the compromise made by the State of source to relinquish its right to tax. In this sense, it was said that “it would by far be the most practical procedure and [...] it would not generally conflict with the interests of the country of source of income if the taxpayer concerned is subject to effective taxation in the State under the legislation of which he is fully liable to tax and this fact is substantiated.”[74] Further, it was found “reasonable for the countries to be given an express option of making the application of the rules of the Agreement conditional upon a claim for tax having <u>actually</u> been raised by several quarters against the same taxpayer.”[75]

Secondly, the discussion also considered “whether or not the waiving of taxation by the country of source should be conditional upon the person concerned not being a national of the country of source”[76]. Finally, the question of whether the benefits of the agreement in the State of source “should be conditional upon the taxpayer’s stay in the other country having been of a certain duration”[77] was also raised.

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71 The potential for a conflict was recognised in the case of the state of source interpreting the concept of residence as narrowly as possible to restrict the application of treaties. The same was said to be possible in the case of States sustaining high level of taxation, so as to prevent taxpayers from moving out to States in which the level of taxation was lower.

72 FC/WP2(57)1, at p.8.

73 According to the Economists, “It is clear, therefore, that in order to avoid double taxation, domicile or habitual residence must everywhere be interpreted alike for the purposes of taxation [...] so that there will be no possibility of misinterpretation”, see LON, E.F.S.73.F.19, at p.25[4029].

74 FC/WP2(57)1, at p.8.

75 Emphasis in the original, see FC/WP2(57)1, at p.9.

76 FC/WP2(57)1, at p.8. This condition was considered due to its use by the United States.

77 FC/WP2(57)1, at p.8.

Irrespective of the outcome of the discussion introduced by these suggestions, which will be explored in detail in subsequent parts of this work, the idea behind them is the mistrust in domestic definitions. The possibility of unilaterally setting up the rule that grants access to tax treaties would arguably introduce an important deal of uncertainty in relation to their application. As a matter of fact, despite its initial conviction in using domestic law as a platform for treaty residence, at a certain point the OEEC started to acknowledge the relevance of "the question of limitations on this concept and the extent of such limitations."[78]

After a reasonable time had passed since these questions were first examined, signed conventions between member States were evaluated in order to verify whether the model provisions were actually being used. The study revealed that almost half the treaties tested deviated substantially from the definition of residence proposed by the OECD[79]. Most States preferred a formula stating that "a resident of Country A means any person who is resident in Country A for the purposes of Country A's tax"[80]. Regardless of the fact that the OECD acknowledged its failure to create a model rule[81] and somewhat surprisingly, the following report on the subject stated:

> 'Without knowing the reason, the Working Party are inclined to believe that the trend towards the formula cited above [...] arises from the fact that the nature of the liability "to taxation" mentioned in paragraph 1 of Article 4 is not defined in that paragraph. It is only when one reads the Commentaries [...] that it becomes clear that the expression "resident of a Contracting State" is not intended to include an individual who is considered as resident in that State according to its national law, if he is subject only to a limited taxation in that State on income arising there. This has led the Working Party to a consideration of the question whether any change in paragraph 1 of the Article is necessary so as to put the matter beyond doubt. A simple change, which would appear to be effective, would be to insert the word "unlimited" before the word "taxation"'[82].

The observations made by the OECD come as a surprise, to say the least, because it is clear that the deviation was a consequence of the inefficiency of the definition of residence in materialising the *renvoi* to domestic law[83]. It was, without a doubt, not the kind of tax liability that created difficulties but the use of the term itself. The rather unclear meaning of the definition proposed by the OECD set up obstacles or standards for defining residence in a treaty on the basis of domestic law alone, so the States adopted a clearer, more congruent and straightforward formula.

The OECD, on the contrary, proposed an even more complicated provision that was finally not adopted. In any case, irrespective of the fact that the text of the definition did not change after this discussion, the attempts by the OECD to restrict the definition of residence did not cease. Several changes have been made to Art.4 OECD MC and its Commentaries afterwards (i.e. the exclusion of conduit companies and dual residents), which have arguably curbed the definition of residence from a treaty perspective[84].

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78 FC/WP2(57)1, at p.10.

79 The study was carried on ten years later and comprised conventions signed between 1963 and 1967. In 10 out of 22 treaties, the rule of treaty entitlement was substantially different. It is interesting to notice that the remaining 12 conventions were grouped under the criterion "identical or not essentially different", therefore not clarifying the cases in which the rules proposed as a model were actually acting as such. See TFD/FC/231, at pp.3-7.

80 TFD/FC/231, at p.7.

81 FC/WP28(68)1, at p.2.

82 DAF/FC/71.5, at pp.2-3.

83 Today, Australia employs such a formula in almost all its treaties so as to avoid the uncertainty behind the Model's definition, see Dirkis, Michael, 'Australia' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.230; and also Dirkis, Michael, 'Australia' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.332.

84 The extent of those changes and their effects for the purposes of tax treaty interpretation are explored in Chapter 7 and Chapter 10.

There is indeed some perceived danger in leaving the definition of treaty residence to the domestic laws of the contracting States, yet domestic residence is a sensitive matter. Throughout the history of its Model, the OECD has struggled to strike a balance between providing certainty through harmonisation, and the risk of overreaching in relation to its member States' national authority. There has always been a tension between the degree of autonomy that tax treaties require (to impose conditions for their use) and the exercise of domestic sovereignty[85]. Yet, it is undeniable that a domestic construction of residence bears significant consequences for the interpretation and application of tax treaties[86]. These difficulties explain the many attempts by the OECD to restrict their scope of application through promoting a given interpretation of Art.4 OECD MC. However, this problem has other undesirable effects. Arguably, the use of domestic residence as the sole factor to decide whether tax treaties apply or not may have significant consequences when attempting to identify the purpose behind an agreement of such nature.

2.4.2. Domestic residence and the object and purpose of the OECD MC

The discussion introduced by the OECD in relation to the source for the definition of residence raises some fundamental questions regarding the object and purpose of tax treaties. Arguably, the determination of the subject entitled to treaties only on the basis of domestic law bears important consequences for the recognition of this object and purpose.

At a certain point, while the need for a definition of residence in the case of residence-source conflicts was being discussed, a fundamental observation was made that, regrettably, went entirely unnoticed. The Delegate for France stated that:

> "[…] it would be useful to seek a common definition of fiscal domicile. This should not necessarily supersede the national concepts, but it would restrict their application so that cases of double taxation could be settled."[87]

This observation was made at the Fiscal Committee, while its members were examining a draft proposed by Working Party 2 that, amongst other things, included a subject-to-tax clause from the perspective of the State of source[88]. It is relevant to emphasise that the issue was raised while discussing the need for effective taxation in one of the contracting States as a condition for treaty benefits to be granted in the other State. The fact that Working Party 2 considered it reasonable and natural to give the contracting States the option of including actual taxation as a condition for treaty benefits, unequivocally demonstrates that taxation was not a requirement for tax treaty entitlement to be recognised. Such a conclusion should not be striking, insofar as it derives from treaty residence being based on domestic law.

To leave the definition of residence entirely to the domestic law of the contracting States implies the assumption that most countries do not impose effective taxation as a requirement to be considered a resident under their laws. Accordingly, if the Model does not require effective taxation for treaty entitlement to arise, the likelihood of treaty claims outside the scope of a

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85 Christians, Allison, 'Sovereignty, Taxation and Social Contract', in 18 *Minn. J. Int'l. L.* 99, (2009), at p.126.

86 For an analysis of some other issues that may be raised from the use of domestic definitions for the purposes of treaty entitlement see Avery Jones, John, et al., 'Round table: On the desirability to change Article 4 OECD Model Convention and its Commentary', in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at pp.650-653.

87 FC/M(57)2, at p.5. He had already mentioned the need of looking for objective criteria so as to set a common definition of residence for all cases, and not only for the purposes of the tie-breaker, see FC/M(56)2(Prov.), at p.4.

88 The provision stated: "Where the right to tax has been conferred on a Member country by this Agreement but is not exercised by that country, this Agreement shall not prevent taxation in another Member country", see FC/WP2(57)1, at p.3.

double taxation convention inevitably increases. The Delegate of France must have wondered what the reason was for allowing access to a treaty *for the avoidance of double taxation* to persons who were not effectively subject to that predicament. His observation illustrates what the courts have recognised for a long time: "double taxation is neither a condition nor a prerequisite for invoking the protection of the treaty"[89].

If neither the laws of the States nor the rules of treaties impose taxation as a requirement for residence, then there are no reasonable ways of arguing that the agreement is meant to operate only in scenarios of double taxation, let alone to sustain that this is its main and foremost purpose. On the contrary, the field is left wide open to contend that the avoidance of double taxation only results as a natural effect of an agreement based on a pre-renunciation of the right to tax[90] that is also apparently immutable[91].

Unfortunately, the observation made by the Delegate of France did not generate any deliberations. Instead, the OECD focused on the need to disregard the expression "full liability"[92] and to refer, instead, to more general concepts. Today, literature still struggles with this proposition, trying to ascertain, with a reasonable degree of clarity, what the object and purpose behind the OECD MC is.

This, of course, does not imply that a Model for the avoidance of double taxation cannot be based on a domestic definition of residence. It most certainly can. However, there is a fundamental difference between using a domestic attribute as a point of departure and to define treaty entitlement solely on the basis of it. A purely domestic definition of residence will inevitably pose obstacles for the application of tax treaties only to cases of double taxation, for such an interpretation will always collide with each State's sovereign right not to tax[93].

To sum up, the existence of this debate suggests two things. Firstly, that absent any other provision in a treaty (such as a limitation-on-benefits rule), the place to set up any boundaries to treaty benefits lies, essentially, in the definition of residence[94]. This rule, after all, describes the nature of the link a person must have with a given State in order to claim the benefits of tax treaties. Secondly and more fundamentally, the discussion introduces the question of the pertinence of a fully domestic definition of residence in a treaty the main purpose of which is, allegedly, the avoidance of double taxation.

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89 Federal Tax Court Canada, 22 January 1985, *The State of the Late John N. Gladden, Plaintiff, and Her Majesty The Queen, Defendant*, 85 TC 5188, at para.20.

90 "The double taxation arrangements contain in the situations here described a pre-renunciation by one state in favour of the state which is to have the right to tax", see FC/WP2(56)1, at p.5.

91 "The rule proposed by the Working Party aims only at the apportionment of the right to tax which is attached to residence, but it can never result in a residence State acquiring the right to tax an income which, as the residence State, it has renounced its right to tax", see FC/WP2(57)2, at p.2.

92 See FC/M(57)2, at pp.5-6.

93 "The treaty can limit taxing rights, but it can't force the country to impose a tax", see Ault, Hugh J., 'The Importance of International Cooperation in Forging Treaty Policy', in 26 *Brook. J. Int'l. L.* 4 (2001), at p.1695. This coincides with the position of the Australian Tax Authorities on the matter, insofar as they explain that "[…] a country is never required by a DTA to exercise a taxing right under that DTA if it does not wish to", see Australian Taxation Office, Taxation Ruling 2001/13, Income Tax: Interpreting Australia's Double Tax Agreements, at p.8. The Australian position in relation to tax treaties is analysed in detail, see infra, Chapter 9, at pp.117ff. See also Easson, Alex, 'Do We Still Need Tax Treaties?', 54 *Bulletin for International Taxation* 12 (2000), at p.624.

94 In fact, when the subject-to-tax clause was proposed, Working Party 2 declared that the discussion was attached to the definition of residence because: "The provision has presumably its natural place in connection with the provisions which determine which of the countries has the right to tax, and it is, therefore, included here", see FC/WP2(57)1, at p.9.

Considering the fact that such a requirement is rarely imposed by the laws of any State, a fully domestic definition of residence does not appear to belong to a treaty for the avoidance of double taxation. On the contrary, the recognition of treaty residence being based solely on domestic provisions nourishes the idea of tax treaties simply aiming to allocate tax jurisdiction[95]. Along with other factors (explored in other parts of this study), the domestic source of the definition of residence seems to be of relevance in relation to the difficulties in identifying the object and purpose the agreement seeks to accomplish.

2.5. Evaluation: A definition of residence for all treaty purposes

History indicates that the rule of Art.4 OECD MC defines the term 'resident' for any case in which the Model needs to be applied, and not only to cases of dual residence. This implies that, even when confronting a residence-source situation, the existence of only one definition of residence at the domestic level is not adequate to provide a solution to the problem. As a matter of fact, in such a case the treaty claimant must meet the requirements imposed by the definition of residence in Art.4 OECD MC as well. Thus, even if it sounds obvious, at least before all the elements at the core of this provision have been examined in detail, stating that the rule is only meant to set out a redirection to the laws of the States dealing with residence is not entirely accurate. The rule of Art.4 OECD MC clearly indicates what the term 'resident of a contracting State' *means* for the purposes of the application of tax treaties.

The intention of steering away from the idea of conceiving treaty residence solely on the basis of domestic residence is fairly evident when one analyses the many attempts by the OECD to promote an interpretation of the term 'resident', to the effect that not *all* domestic residents would be entitled to the benefits of the Model. From the perspective of its history, both the issues of treaty abuse and double non-taxation seem to find their origin in this discussion. Arguably, there are reasons to sustain that even some of the problems in identifying the object and purpose of tax treaties derive from the conceptualisation of residence as a purely domestic issue. The fundamental question this raises aims, logically, at explaining if the elements at the heart of Art.4 OECD MC set out some threshold for measuring the appropriateness of a tax treaty claim, and if the definition is in fact apt to do so.

A crucial piece in this puzzling question is the expression 'liable to tax', at the core of the definition of residence. Under Art.4 OECD MC, residence *means* 'liable to tax'. While this seems to suggest that the scope of the term 'resident' is given by the meaning attributed to the term 'liable to tax', one cannot help but conclude that the question of whether domestic residence equates to treaty residence ultimately depends on the meaning of this expression. Thus, before answering the question of whether domestic residence is sufficient to access tax treaties, an effort must be made to attribute this expression its ordinary meaning.

What is clear, however, is that the history of Art.4 OECD MC indicates that the scope of the definition of residence is limited to the application of the particular tax treaty in the context of which its meaning is analysed. In principle, the term resident is defined 'for the purposes of this convention' *only* and therefore the rule does not have the ability to modify the laws of the contracting State dealing with that issue.

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95 See infra, Chapter 9, at pp.117ff.

3. Chapter 3
Sources of tax liability: 'Under the laws of that State'

3.1. Introduction: The term resident means liable to tax

The fundamental question of whether the OECD MC contains a definition of residence that is different from that at the domestic level depends on the meaning attributed to the term 'liable to tax'. The rule of Art.4 OECD MC has been designed to stress the fact that the term 'resident of a contracting State'[96] *means* 'liable to tax', and therefore not any domestic resident should automatically obtain the recognition of treaty residence[97], otherwise the formula should have been another one[98]. Instead, only those domestic residents who may also be qualified as 'liable to tax' under the description of the term made by the OECD would be granted access to tax treaties.

The answer to the question of whether domestic residence is in fact capable of generating treaty residence is therefore subject to the meaning attributed to the term 'liable to tax'. Whether a tax-exempt pension fund or a conduit structure meets the criteria for being granted the status of 'resident of a contracting State' under Art.4 OECD MC depends ultimately on the significance of this expression. Thus, when looking for an answer to the many questions in the sphere of treaty entitlement, for instance if any persons may be excluded from the subjective scope of tax treaties, one must always keep in mind that it is the term 'liable to tax' which, at the outset, governs their application.

Several problems arise, however, from this simple conclusion. In general, the use of this undefined treaty term seems to suggest that, under Art.3(2) OECD MC, the States are allowed to look at their laws to provide a definition to the term, unless the context otherwise requires. This, however, does not seem to be an efficient way of solving any discrepancies arising from a different conceptualisation of tax liability amongst the contracting parties. The case of transparent entities is a clear example. While one State may define tax liability in a way in which such an entity is included within the scope of the Model, its counterparty may sustain a different position. This would result in the creation of obstacles for a coherent interpretation of the OECD MC. The source from which the meaning of the term must be extracted is therefore a fundamental aspect of the definition.

3.2. Tax liability in a contracting State under its laws

Residence, for the purposes of tax treaties, is based on tax liability. Tax liability, in turn, must be verified 'under the laws' of the respective States. Irrespective of the fact that Art.4 OECD MC apparently contains a definition of residence for treaty purposes, the history of the Model indicates that its purpose was to encompass "the different national concepts"[99] used by the States to extend their tax jurisdiction. Despite their many evident differences, the term was intended to be able to reconcile them all.

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[96] The expression 'resident of a contracting State' was used for the first time in 1959, see C(59)147(Final), at p.6.

[97] Vogel for instance understood that the definition imposed standards (a locality-related attachment) for domestic residence in order to give place to treaty residence, see Vogel, supra note 6, at p.183.

[98] The options would have been either to leave the term resident undefined, or to include a definition such as "the term resident of State A means any person who, under the laws of State A, is considered to be a resident therein". This alternative is explored in detail in Chapter 9, section 9.2.

[99] FC/M(57)2, at p.5; Couzin, supra note 20, at p.104.

For such a concept to be capable of identifying the elements at the core of the diverging definitions of residence around the globe, the first thing to consider was the fact that domestic tax liability derives from an act of national sovereignty. Such an act is materialised through different legal instruments in each State and, on account of that, the Delegation of Switzerland proposed the following draft:

> "For the purposes of this Convention, an individual or a legal person shall be deemed to be domiciled in the State in which he or it is fully liable to taxation *under the internal law*, by reason of his or its domicile, head office or residence, or by reason of any other similar criterion"[100].

Tax liability is thus a product of domestic sovereignty. It is precisely in "virtue of their sovereignty, [that residence] may be fixed by the individual states at their own discretion"[101]. By referring to domestic law the OECD has recognised the autonomy of the States to set their own rules of tax jurisdiction[102]. Any time a treaty claim is raised, accordingly, that claim must be grounded "on the basis of the internal concept of residence of that State"[103]. In other words, there simply cannot be treaty residence if the person is not first considered to be a resident under the laws of the relevant State. A well-known case, ruled by the Supreme Court of Canada, presents an interesting opportunity to deal with this analysis.

In the Crown Forest case[104], Norsk, a company incorporated in the Bahamas, had an office in the US engaged in trade and business from where the company was in fact managed. After having sent certain payments to a related Canadian company, the application of the reduced withholding tax in the US-Canada tax treaty was claimed. This claim was based on the allegation that Norsk was a resident of the US by reason of its place of management being located therein.

The Supreme Court of Canada delved largely into the meaning of the expressions contained in Art.4 of the US-Canada tax treaty[105]. It began by examining whether Norsk was a resident of the US according to the criteria listed in the treaty, or by reason of any other criterion of a similar nature[106]. It extensively analysed the relation between Norsk's place of management in the US and the fact that the company was engaged in trade or business therein. After finally deciding that the company was not liable to tax in relation to its place of management in the US, but only by reason of its trade or business, it scrutinised whether those circumstances were constitutive of a 'criterion of a similar nature', so as to give place to residence for treaty purposes. Moreover, it largely explored the parameters under which a criterion may be of a similar nature. It explained the significance of the phrase 'by reason of' as a causal connection[107] and, in general, it analysed every single aspect of Art.4 OECD MC.

Only when the situation had been quite extensively discussed the Court declared:

> "I accept the appellant and intervener's submission that, since the application of the Convention is to be limited to taxpayers bearing full tax liability in one of the contracting parties, then Norsk cannot benefit from the Convention and is consequently not to be characterized as a resident under Article IV, paragraph 1"[108].

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[100] Emphasis added, see FC/WP2(57)2, at p.9.
[101] FC/WP2(56)1, at p.2.
[102] FC/WP2(57)1, at p.4; Englisch, Joachim, 'Germany' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.498.
[103] FC/WP2(56)1, at p.6; and Vogel, supra note 6, n.24, at p.229.
[104] See *Crown Forest*, supra note 13. For an analysis of the case see Ward, supra note 13, at pp.408-424.
[105] *Crown Forest*, supra note 13, at p.806.
[106] *Crown Forest*, supra note 13, at p.810.
[107] *Crown Forest*, supra note 13, at p.815.
[108] *Crown Forest*, supra note 13, at p.823.

Irrespective of the fact that the extensive analysis contained in the Crown Forest case is of unquantifiable value, the path followed by the court was somewhat odd. From the beginning of the analysis, and having actually quoted the relevant provisions that, under US law, determined Norsk tax liability[109], it was relatively clear that such a company was treated as a non-resident in the US[110].

Regardless of the fact that it was clear that Norsk was subject to such treatment[111] (which could have been so stated at the beginning of the ruling), the Court nevertheless attempted to construe a relation of residence between Norsk and the US on the basis of the provisions of the treaty. Once it reached the conviction that the company was not a resident of the US on the basis of the treaty definition of residence, it turned its attention to the issue of residence at the domestic level:

> 'After all, why should entities not regarded as "residents" by a contracting state be regarded as residents of that state for the purposes of the Convention?'
>
> I do not really see anything "tautological" (as alleged by the respondent) about grounding residency under the Convention in actual residency in one of the contracting parties, according to that party's domestic legislation. As noted by the appellant, the Convention was not intended to allow entities to achieve a higher status of residence under its terms that would be available at domestic law[112].

The process followed by the court is peculiar in the sense that it seems to have ignored, in principle, the absence of residence under the domestic laws of the US as a point of departure. On the contrary, it mainly focused on justifying the existence of residence from the perspective of the treaty in isolation.

On account of what has been said so far, one would have expected the analysis to follow a somewhat reverse approach. In other words, the first aspect that should have been analysed by the court was the possibility of considering Norsk to be a resident under the domestic laws of the US, but only on the basis of US law and irrespective of the provisions of the treaty.

This clarification may be considered to be meaningless, bearing in mind that the court did arrive to the right conclusion, which is that of rejecting the tax claim attempted by a domestic non-resident person. However, the situation presents a sensible point in the configuration of residence for treaty purposes inasmuch as it suggests that, under certain circumstances (as in the case of Norsk), a treaty claim may arise even in the absence of residence under the laws of a State[113].

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109 *Crown Forest*, supra note 13, at pp.809-810.

110 Vann, supra note 41, at p.246.

111 In cases of companies engaged in trade or business in the US there is the potential for 'residence like' taxation in the sense that all income effectively connected to that trade or business will be taxed in the US. The company, however, is not regarded as a US corporation under the Internal Revenue Code for any tax purposes, it is not a resident under domestic laws, and in fact the rules of taxation are restricted only to that effectively connected income, see Brauner, Yariv, 'United States' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.871. Inasmuch as this is the case, the situation is similar to that of a permanent establishment which, under the application of a non-discrimination clause such as Art.24(3) OECD MC, claims for taxation to be not less favourably levied, compared to the rules applicable to resident companies carrying on the same activity. While this would certainly imply 'residence like' taxation in the case of that permanent establishment, the rule is nothing but a fiction that, moreover, should be interpreted restrictively. That permanent establishment could not be considered to be a resident of any of the contracting States for other treaty purposes.

112 *Crown Forest*, supra note 13, at p.832-833.

113 In a similar case commented by Vogel, the Federal Court of Canada, instead of checking whether the person was treated as resident domestically before applying the treaty, proceeded to construe treaty residence on the basis of domestic circumstances and their ability to constitute 'any other criterion of a similar nature', see Vogel, Klaus, 'Tax Treaty News', in 57 *Bulletin for International Taxation* 5 (2003), at pp.182-183.

Under the provisions of Art.4 OECD MC there cannot be residence for the purposes of tax treaties if that residence is not based on residence at the domestic level. In other words, a person that is treated as a non-resident for domestic purposes can under no circumstances be treated as a resident for the purposes of the application of the OECD MC. Only if a treaty claimant meets the essential requirement of residence at the domestic level or, in other words, only if a person is not treated as a non-resident under the laws of a certain State, the analysis of the provisions of Art.4 OECD MC in relation to that person may be rightly carried on. The entire conflict of residence in Art.4 OECD MC and therefore its study must depart from the existence of a person who is a resident of at least one of the States under its laws and, in the case of the Canada-US treaty, this was clearly not the case. By claiming treaty residence while being a domestic non-resident, Norsk was, in fact, trying to enter the treaty "through a door that [had] already been closed[114].

The use of the expression 'under the laws of that State' reinforces the idea that treaty residence must be, before anything else, residence as conceived by the domestic laws of a State and not solely on the basis of the interpretation of the treaty. The structure of Art.4 OECD describes a relation between those domestic rules and the possibility of being a resident for tax treaty purposes that targets the domestic laws of the States or any equivalent manifestation of a State's sovereign power. Each State is left free to decide whether a person is considered to be a resident therein and the means to do so is in its laws, and those rules are the keystone over which treaty residence must be construed.

3.3. 'Laws' of a State: Broad and narrow conceptualisation

A ruling by the *Hoge Raad* of the Netherlands has led to opposite views in relation to the extent of the reference to the 'laws' of a State. In that case[115], the shareholders of a company incorporated in the Netherlands moved their residence to Belgium, while at the same time shifting the place of effective management of the company to the Netherlands Antilles.

At a later point in time and having received income from a share buy-back in respect of shares of the same company, the shareholders claimed the benefits[116] of the Netherlands-Belgium tax treaty. The tax authorities of the Netherlands, however, denied such benefits based on the argument that the company, having moved its place of effective management to the Netherlands Antilles, was no longer a resident of the Netherlands for the purposes of the treaty invoked[117]. A key element considered by the court in sustaining its position was the Tax Arrangement for the Kingdom of the Netherlands[118] (hereinafter also referred to as "BRK"), an instrument that allegedly affected the application of the Netherlands-Belgium tax treaty[119].

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114 Federal Court of Appeal of Canada, *Her Majesty the Queen v. Crown Forest Industries Limited*, 94 DTC 6107, at p.6115, dissenting opinion by Décary, in *Crown Forest*, supra note 13, at p.821.

115 Hoge Raad, *case 35.557*, supra note 57.

116 Under Art.10 of the Netherlands-Belgium tax treaty, the income was treated as dividends and so the shareholders claimed the reduced rates of withholding tax (10% instead of the regular 25%) for the income flowing from the Netherlands to Belgium, where they resided.

117 Under Art.4 of the treaty between the Netherlands and Belgium. For Art.10 of that treaty to operate, a company resident in one of the contracting States had to distribute dividends to a resident of the other contracting State.

118 The *Belastingregeling voor het Koninkrijk* (BRK) regulates the situation of the different parts of the Kingdom of the Netherlands. The instrument operates in the same manner as a multilateral tax treaty. It has been sustained that the consideration of this instrument in this case derived from a provision in the Protocol of the treaty between the Netherlands and Belgium, which amplified the scope of the term 'laws' by referring to "the relevant laws of that State as amended or supplemented on the basis of international agreements". To some, in the absence of such a provision the Hoge Raad would have ruled differently, see Simader, Karen, 'Austria' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at pp.403-404. This position

Irrespective of the different views expressed in literature as to the appropriateness of considering such an instrument as part of the 'laws' of the Netherlands for the purposes of applying the Netherlands-Belgium tax treaty[120], the discussion raises a question in relation to the meaning of the expression 'laws' in Art.4 OECD MC. The ability of an international arrangement (such as the BRK) to amend or supplement the laws of a given State depends ultimately on the particularities of the legal system of that State[121].

Hence, broadly or narrowly considered, the 'national laws of a State'[122] symbolise any rules through which the respective States determine the extent of their tax authority[123], which is a matter of their constitutional order. The aim of the OECD in using the term 'laws'[124] was to define tax liability from the perspective of the rules of the States, without any reference as to the particular type of instrument through which that relation should be envisaged. Some States will opt for a traditional nomenclature and use laws. Others will determine the scope of domestic tax liability through decrees or royal decrees. The form under which a State exercises the exclusive prerogative of delimiting its sovereign power is, in principle, irrelevant.

The reference to the laws of a State is a way of materialising a generic redirection to the domestic rules of the States, as defined by each State in exercise of their sovereign power. By way of illustration, the laws of France[125], the UK[126] and Canada[127] expressly declare that a dual resident

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has nevertheless been debated, see Smit, supra note 57, at pp.155-158.

119 Regardless of the fact that the BRK's qualification as an international agreement is debatable, it contains a rule similar to the tie-breaker in the OECD MC to the effect of breaking the tie in relation to persons who are residents in different parts of the Kingdom which, for the purposes of its application, are taken as independent States. The reason to exclude the claimants from the scope of the Netherlands-Belgium treaty was the presence of limited tax liability due to the operation of BKR. Curiously, however, in these cases, under the laws of the Netherlands, the person's status as a resident does not change at the domestic level, inconsistency that was noticed by van Raad as early as in 1988, see van Raad, supra note 32, at p.242.

120 According to Frank Engelen, the BKR should be considered to form part of the 'laws' of the Netherlands, see Engelen, F., FED 2001/315, at p.1321; van Raad, Bender and Douma argue that Art.3(1) of the Netherlands-Belgium tax treaty restricts the 'laws' of the Netherlands only to those laws applicable to the territory of the Netherlands in Europe, see van Raad, C., Bender, T., and Douma, S., 'De Hoge Raad op een drielandenpunt', *Weekblad voor Fiscaal Recht* 6431 (2001), at p.535. See also Damen, Stephan, 'Netherlands Supreme Court Rules on the Residence of Dual Resident Companies under Tax Treaties with Third Countries', 55 *Bulletin for International Taxation* 7, (2001), at pp.290-292.

121 This question was left unanswered by the *Hoge Raad*, see Smit, supra note 57, at p.158.

122 As expressed in the original formula, see FC/WP2(57)3, at p.6, and in the draft article, see Annex, at p.11: "In the present Convention, unless the context otherwise requires: […] The term "resident" of a State mean any person who, under the national laws of that State, is subject to tax in that State as a resident'.

123 Vogel, supra note 6, n.3, at p.77.

124 It is worth mentioning that the draft rule made reference to "the national *law* of that State" (singular emphasised), see TFD/FC/27, at p.1. The use of the terms 'law' and 'laws' in the OECD MC has been extensively analysed, see Pijl, Hans, 'The Excluded Resident and the Term "Law"/"Laws" in Article 4 of the OECD Draft (1963) and OECD Model (1977/2010)', in 68 *Bulletin for International Taxation* 1 (2012), at pp.3-25. For the purposes of this study, however, the distinction between law, laws, legislation or any other equivalent terminology is not relevant, inasmuch as in all cases the reference is clearly made to the rules that, in the sphere of domestic fiscal sovereignty, establish tax liability. In fact, a variety of terms was used to materialise the redirection, which seems to suggest that the precise term was not as important as the idea behind it, see FC/M(58)I, at p.3; FC/WP2(58)1, at p.3 referring to 'the general legislations of the various States' and 'the national rules of law of the contracting States'; the 'internal law' of the States in C(58)118, Part I, at p.13; 'under their internal legislation' and 'the national legislations of the various States' in FC(58)2(1st Revision) Part II, at p.16. Vann, in fact, describes the modification as 'largely cosmetic', see Vann, supra note 41, at p.238.

125 By way of illustration, in the case of France, the question has been raised whether a French resident should be treated as a non-resident if the tie-breaker is lost, and the answer has been affirmative only because of the hierarchical superiority of treaties in relation to domestic law provided for in the constitutional laws of France, see Delattre, Olivier, 'The Tax Residence of Individuals', 39 *European Taxation* 6 (1999), at p.203.

that loses a tax treaty tie-breaker is to be left outside the scope of the domestic definition of residence and, consequently, of other treaties. It is thus clearly appropriate, under the laws of those States, to consider such persons as non-residents for domestic purposes and, accordingly, for the purposes of the application of other tax treaties.

It must be borne in mind that where the laws of the States do not specify the need to exclude certain persons from residence for the purposes of applying tax treaties, or recognise the supremacy of such treaties over domestic law[128], the OECD MC does not contain any such restrictions[129]. Accordingly, applied in isolation, the rules of the Model should only affect the situation of the persons claiming its benefits. In other words, as was stated earlier, the rules of the OECD MC operate only 'for the purposes of this convention'[130].

3.4. The use of 'that State': Rules under which tax liability is defined

3.4.1. 'That State' as the State of residence: An exception to Art.3(2) OECD MC

Every time a tax treaty is invoked, the treaty claimant must deal with the application of the treaty both in the State of source, where a reduced rate of withholding tax may be applied, and in the State of residence, by requesting the application of the rules of credit or exemption. In doing so, the treaty claimant must deal with two opposed interests, represented by the views of each State in relation to the recognition of residence for treaty purposes. A crucial piece of this conflict lies in the determination of whether a person is 'liable to tax'. As an undefined treaty term, the use of the expression begs for the application of Art.3(2) OECD MC, according to which the meaning of a treaty term must be sought under the rules of the State *applying the treaty*, unless the context otherwise requires[131].

One may argue that both States apply the tax treaty, each on its own dimension; or that only the State of source applies the treaty, because its domestic rules are restricted when a treaty becomes applicable[132]. In any of these cases, it is relatively clear that, when applying a treaty, either each State, or solely the State of source, would tend to look at its own laws for a definition of 'liable to tax'. Yet, according to the words of Art.4 OECD MC, this does not seem to be adequate.

The drafting of the rule of residence was made so as to stress the fact that it is under the domestic tax laws of *that* State, the State claiming to be the State of residence, without any consideration for

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126 United Kingdom FA 1994 Section 249(1); HJI Panayi, Christiana, 'United Kingdom' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.848.

127 Canada Income Tax Act, section 250(5); Brooks, Kim, 'Canada' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at pp.438-439.

128 Avery Jones, J., 'The interaction between tax treaty provisions and domestic law', in Maisto, G., (ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), at pp.137-140.

129 Sasseville in fact describes the convenience of aligning residence at the domestic level and treaty residence, but he acknowledges that few States have actually done so, see Sasseville, supra note 58, at pp.45-48, and also 'Round table: Improving the relationships between tax treaties and domestic law', in Maisto, G., (ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), at p.397.

130 See supra, Chapter 2, section 2.3; and infra, Chapter 12, section 12.2.4.

131 Art.3(2) of OECD Model Convention. See also Vogel, supra note 6, at pp.51-60.

132 According to Avery Jones only the State of source applies the treaty, Avery Jones, J. et al., 'The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model', 1 *British Tax Review* (1984), at p.50; see also Kandev, Michael, 'Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model', in 55 *Canadian Tax Journal* 1 (2007), at p.38; to Engelen and Pötgens both States do, see Engelen, F., and Pötgens, F., 'Report on "The Application of the OECD Model Tax Convention to Partnerships" and the Interpretation of Tax Treaties', 40 *European Taxation* 7 (2000), at p.257.

the laws of the State of source[133], that the term 'liable to tax' needs to be defined[134]. If its intention had been different the OECD would have used a terminology such as "under the laws of a State" or "under the laws of one of the Contracting States"[135].

The fact that "it will be incumbent upon the taxpayer to supply facts from which a residence in the other contracting State may arise"[136], does not imply that the other contracting State (commonly referred to as the state of *source*), may seek to define the term according to its own rules. The specific character of the reference implies that, having demonstrated that the laws of the State of residence define the term 'liable to tax', the other contracting State should refrain from denying the benefits of the convention if the treaty claimant meets the test[137].

Needless to say, it may occur that both contracting States claim to be the 'residence' State. In such case, one would have to analyse whether the domestic rules of each State meet the test imposed by the treaty definition of residence (as set out in Art.4(1) OECD MC) and, if both do, the tie-breaker contained in the Model will become applicable to solve the problem.

According to Art.4 OECD MC, the rules of the State claiming to be the State of residence alone serve to determine whether a person is a resident of that State. Therefore, Art.4 OECD MC sets out an exception to the reasoning contained in Art.3(2) of the Model, in relation to the attribution of its meaning to a treaty term, under the laws of the State *applying the treaty*. Thus, it would not only be strange if the test is applied attending to the rules of the State of source[138], but it would also be inappropriate. The construction of the term 'resident of a contracting State' is quite accurate: The expression 'under the laws of *that* State' cannot be ignored[139] in setting out the rules under which the term 'liable to tax' needs to be defined.

3.4.2. 'Liable to tax' as an undefined treaty term, under the laws of *that* State

The exclusive reference to the laws of *that* State, meaning the State of residence, when seeking to identify the meaning of the term 'liable to tax' has also other implications. Assuming that the laws of such State do not define in its laws the term 'liable to tax', which is in fact fairly common, one would have to attribute the expression its meaning under public international law.

Regardless of the many aspects involved in the attribution of its meaning to the term (explored extensively in a subsequent part of this study[140]), once the process is through and the meaning of 'liable to tax' has been identified, then, naturally, the States will seek to confront whether the treaty claimant meets the conditions imposed by the term. When making this comparison, the State of source may advocate for its own narrow conceptualisation of 'liable to tax', while its counterparty may logically seek to impose its broader construction of the term.

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133 Van Weeghel, Stef, *The Improper Use of Tax Treaties*, (London: Kluwer, 1998), at p.41.
134 Widrig, supra note 14, at p.274.
135 Lang, Michael, ''Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law', in 55 *Bulletin for International Taxation* 12 (2001), at pp.597-598.
136 Vogel, supra note 6, at p.230.
137 Or at least not from the perspective of the definition of residence. This does not imply that under other rules, such as general anti-abuse rules or limitation-on-benefits provisions, these benefits cannot be denied.
138 Fantozzi, Augusto, et al., 'Round Table: The issues, conclusions and summing-up', in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.929.
139 Lang, supra note 135, at p.597.
140 This question is extensively explored in Chapter 9.

Yet the question of whether a person meets the definitions of the Model in this particular case needs not to be addressed from the perspective of each State's own standards[141] because, in this sense, the reference to the laws of the State of residence plays a fundamental role as well.

As was stated earlier, the OECD has been very precise in identifying the rules based on which residence needs to be defined in the sphere of tax treaties, by making reference to only one of the contracting States. The reference to the laws of *that* State points only in the direction of the laws of the State of residence[142], capable of resulting in the appearance of tax liability, as the rule so clearly indicates, *therein.* In fact, Art.4 OECD MC has been historically built on the assumption that the State of source would "presumably not often make any test to ascertain if the circumstances provide reasons for considering that the taxpayer is [a resident] in the other state"[143]. On the contrary, every time a treaty is entered into "each of the states must be presumed to have made a mutual examination of the concept of [residence] of the other state and found it satisfactory; for the rest a state will always have a possibility of termination its tax renunciation by denunciation of the agreement"[144].

When testing whether the conditions imposed by the treaty term are met, one must only look at the rules of the State of residence, because it is under the laws of *that State* that the treaty claimant must be qualified as 'liable to tax'. This implies, as has been explained previously in relation to the Crown Forest case, that under Art.4 OECD MC the views of the State of source as to the tax liability of the treaty claimant are irrelevant when applying a treaty, and so are the rules of the Model if they are applied in isolation.

3.4.3. Art.4 OECD MC according to the Partnership Report[145]

It is relevant to highlight, even at this preliminary stage, that the exclusive role played by the laws of the State of residence in characterising a person as a treaty resident is restricted to the recognition of that very precise attribute. They do not entail any other consequences for the purposes of applying a tax treaty. In other words, the fact that the State of source must respect and follow the recognition of residence under the laws of its counterparty (even if under its own rules a certain person would not have been so characterised), does not imply that the State of source must observe the laws of the State of residence in any other respect.

This is quite relevant considering the interpretation of Art.4 OECD MC that the Partnership Report has attempted to introduce. According to the OECD's official position, in the presence of a conflict of attribution of income the State of source must follow the position held by the State of residence[146]. This interpretation, however, refers only to an issue of attribution of income, which

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141 Vogel has said that the issue of residence "is a question which each State may examine on its own", see Vogel, supra note 6, n.25, at pp.229-230. A similar observation has been made in the case of the Netherlands, see de Boer, Reinout, 'Netherlands', (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.590.

142 Lang, supra note 135, at pp.597-598; Hull, Howard, 'United Arab Emirates: Tax Treaty Relief on International Investment', in 63 *Bulletin for International Taxation* 2 (2009), at pp.57-58.

143 FC/WP2(56)1, at p.7.

144 FC/WP2(56)1, at p.7.

145 OECD, *The Application of the OECD Model Tax Convention to Partnerships*, (Paris: loose-leaf, 1999); Sec.6.3 of Comm. to Art.1 OECD Model Convention (2014).

146 Sec.6.3 of Comm. to Art.1 OECD MC indicates that there is a "principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident."

is essentially different in nature to the issue of whether a person is a resident for the purposes of tax treaties.

Both determinations are undoubtedly entangled, inasmuch as the person to whom the income is attributed will have to meet the conditions of residence in the relevant State for treaty benefits to apply. However, the requirements in each case aim at different aspects. Regardless of the fact that such an interpretation will be explored in a subsequent part of this work[147], it is worth mentioning that, in principle, the supremacy of the laws of the State of residence in determining of the scope of application of the Model does not foster an interpretation such as that introduced by the Partnership Report.

3.5. Evaluation: The term 'resident' and the exception to Art.3(2) OECD MC

Under the provisions of Art.4 OECD MC, the States are left free to determine the extent of their tax jurisdiction. It is on the basis of such determination that tax treaties are applied.

In order to determine whether a person is 'liable to tax' or not at the treaty level, Art.4 OECD MC contains a generic reference to the *laws* of the relevant State. The use of this particular terminology is meant not to restrict in any manner the juridical nature of the rules through which the States establish the extent of their tax authority. On the contrary, the history of the Model indicates that this is a matter of each State's own constitutional order, and therefore every State is left free to determine the particular instruments through which its tax sovereignty will be extended upon certain persons. Some States might call these rules laws and others decrees or royal decrees. The particular form under which a State exercises the exclusive prerogative of delimiting its sovereign power is irrelevant. The expression 'laws', as used in Art.4 OECD MC, is aimed at covering all those different forms.

The fact that the issue of residence must be observed from a domestic law perspective, however, does not imply that the views of both States are relevant when an attempt is made to define 'liable to tax'. The definition of residence contains an express reference to the laws of only one of the contracting States. Thus, when trying to ascertain the meaning of the term 'liable to tax', one must always keep in mind that Art.4 OECD MC sets out an exception to the logic contained in Art.3(2) of the Model.

Under the definition of residence, the attribution of its meaning to the term 'liable to tax' must not be made from the perspective of the laws of the State *applying the treaty*, let alone from the standpoint of the provisions of the treaty in isolation. The term 'liable to tax' needs to be defined under the laws of the State claiming to be the State of residence. It is only these laws that are relevant for such purposes.

Needless to say, if the laws of the State of residence do not define the term 'liable to tax', then the expression needs to be attributed its meaning at the treaty level on the basis of the elements provided by the Model to do so, which is an entirely different question explored in subsequent parts of this study. Only after having attributed its meaning to the expression at the treaty level, one may be able to test whether, under the laws of the State of residence, the conditions imposed by that meaning are overcome by the treaty claimant.

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[147] See supra Chapter 4.

4. Chapter 4
'Liable to tax' as an attribute of persons

4.1. Introduction

The term 'liable to tax' holds the key to the application of tax treaties. Having been placed at the heart of the definition of residence, it is this term which, at the outset, defines the need to apply the OECD MC. In that context, as has been stated in previous parts of this study, the attribution of a certain meaning to the expression plays a fundamental role, insofar as the amplitude of the definition sets out the personal scope of a tax treaty.

When attempting to confront the many issues derived from the interpretation of Art.4 OECD MC, attention must be paid to the manner in which the definition has been structured. On the one hand, the liability to tax contemplated in the Model is not an abstract one, but has been defined as an attribute of persons. On the other hand, the definition of the term 'person' in Art.3 OECD MC is a comprehensive one. Further, it must also be considered that, according to the Commentaries, no standards are imposed on domestic residents to access tax treaties. Thus, when the question is raised as to the identification of the subject entitled to treaty benefits, the answer appears to be simple: the OECD MC contemplates a broad scope of application.

There are nonetheless several elements in the description of the term 'liable to tax' by the OECD that appear to set out certain *conditions* to access the Model. As a matter of fact, these elements create difficulties when assessing the situation of groups of persons, contractual arrangements and transparent entities, amongst other similar cases in which the identity of the treaty claimant is hard to determine. As a matter of fact, in an attempt to overcome the difficulties derived from the use of transparent vehicles, some courts have granted the benefits of the Model if the relevant income is subject to taxation. These rulings raise the question as to the relevance of the particular item of income the treaty claimant receives when ascertaining its tax liability under Art.4 OECD MC. These are the two basic questions this section aims at confronting.

4.2. Tax liability as an attribute of persons in Art.4 OECD MC

4.2.1. History: A common test for individuals and entities

As Couzin explained in his extensive analysis of the corporate residence test[148], rules on taxation have changed significantly over time. While in principle companies did not form part of the picture[149], they were focused primarily on individuals. Further, given the fact that at that time cross-border activities were not common, the issue was approached in a very geographical manner[150]. With the passage of time, however, this changed. These individuals started carrying on businesses in different locations and therefore trade and investment became international. In an effort to keep up with the new circumstances and in order to protect their tax base, the States changed their approach as well. Instead of focusing on the location where the activities were carried on, they sought to identify an element of allegiance from the perspective of the individual

[148] A most complete review of the residence test from the perspective of its history has been carried out by Couzin, see supra note 20, at pp.25-102.

[149] At that point, the recognition of residence to entities was not an issue, as the mere idea of their separated existence was scarcely accepted, see Couzin, supra note 20, at p.11.

[150] Persons were in general subject to the authority of the State in which their activities were carried on, see Couzin, supra note 20, at p.6.

himself. An attribute was recognised in these individuals which, in very broad terms[151], described their submission to the tax authority of a certain State even beyond its national borders.

Residence, therefore, was originally developed as an attribute of individuals[152]. The expression referred to the place where these individuals would normally be found, a place of abode where their activities were carried out[153]. The test was applied peacefully for years, until it had to face a breaking point. The recognition of a separate existence to entities entailed the need of discussing criteria that would justify taxation in their respect, regardless of the situation of their members. These entities, however, were not born. They did not have an abode, family, friends or interests, so as to give place to an allegiance to a certain State. Yet they concluded contracts, acquired property and, above all, generated significant wealth.

In an attempt to avoid the complexity of having to design a standard of allegiance exclusively for entities, the courts applied to these entities, by analogy, the rules on residence of individuals[154]. Incorporation was homologated to birth and management to a place of interest and, in general, the attributes of individuals were extrapolated to corporations. Although the solution was efficient, the States were forced to recognise entity residence on the basis of criteria that even today seems to be awkward[155] and hard to define[156]. Yet this technique for the determination of residence in cases of entities prevailed.

The strategy of applying the rules intended for individuals to entities has set out the paradigm over which entities have been taxed historically. It is without forgetting this that the issue of treaty residence and all the questions derived from its analysis need to be discussed in current times. The essence of the issue of tax treaty abuse, for instance, lies in the need to explain how it is that an entity showing little economic nexus with a certain State is nonetheless able to claim the benefits of tax treaties. The answer to that question lies in the above-mentioned breaking point. The test for individuals, contrary to what some argue[157], is in most cases weak, excessively left to formalities, and it ignores most of the economic dimension of the person[158]. Such a test, applied by analogy to entities, increases the likelihood of conflicts considering how easy it is to create an entity and thus to manipulate the system. The OECD MC, however, has brought all these problems

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151 Residence is an attribute in the sense that "it must be assumed that every person has at all times a residence. It is not necessary to this that he should have a home or a particular place of abode or even a shelter. He may sleep in the open. It is important only to ascertain the spatial bounds within he spends his life or to which his ordered or customary living is related", Tax Court of Canada, Case *Neil Barry McFadyen v. Her Majesty The Queen*, 2000 D.T.C. 2473, at para.99.

152 Van Raad, supra note 32, at p.241. See also Couzin, supra note 20, at pp.10-23. It is interesting to notice that the mention to the connecting factors in Art.4 OECD MC refers to 'his'.

153 Residence is in fact defined even nowadays as "the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question", see *Neil Barry McFadyen*, supra note 151, at para.99.

154 Couzin, supra note 20, at pp.31-38.

155 It has been said that, "in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties", Graetz, Michael, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies", in 26 *Brooklyn Journal of International Law* 1357, at p.1425.

156 "The problem with drawing an analogy to individual residence is that the cases concerning natural persons rely upon factors that are not so easily migrated to incorporated companies", Couzin, supra note 20, at p.37.

157 To some, in the case of individuals the test is strong and it gives account of a real attachment, which is something that does not happen in the case of corporations. See Duff, David G., "Responses to Treaty Shopping: A Comparative Evaluation", in Lang et al. (Eds.), *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), at p.77; and Vann, supra note 41, at p. 251.

158 One may observe this when appreciating the rules applicable to individuals as a whole, see the round-table on residence of individuals in Avery Jones, supra note 86, at pp.645-667.

to the sphere of the Model by choosing to follow this path[159]. Ideally, the peculiar nature of the entity residence issue should have been acknowledged[160] and a robust test based on the effective economic allegiance of these entities with a given State should have been elaborated[161]. Instead, it was decided that entities would be entitled to treaties on the basis of, for instance, the place where they were *born*. Such a design not only ignores the essential aspect behind the creation of an entity, which is the economic effect it seeks to cause[162], but it also provides breeding ground for the manipulation and misuse of the test[163].

4.2.2. Tax liability in Art.4 OECD MC: An attribute of 'any person'

When the OEEC took over the efforts of the League of Nations to create a tax treaty model, the recommendation given by the Four Economists not to rely on domestic definitions[164] was plainly ignored. Treaty entitlement was in fact analysed and discussed as a domestic issue[165], and the rules dealing with the personal scope of the Model were drafted in equally broad terms. According to its current version:

> "This Convention shall apply to persons who are residents of one or both of the Contracting States"[166].

To suit the needs of a treaty model based on domestic law, created with the aim of harmonising the different concepts of residence used by the States members to the OEEC[167], the definition had to be able to adapt to any tax system. A first step in doing so was to define the term 'person'[168] as broadly as possible. As it stands today, the definition includes individuals, companies, any body corporate or entity which is treated as a body corporate for tax purposes, and any other body of persons[169].

While the definition of 'person' does not seem to pose any difficulties in the case of individuals or corporations[170] (the singularity of which may be easily established), its broadness is problematic in the case of certain groups of persons. Some States have recognised transparent entities[171], entities without legal personality[172], entities with little tax capacity[173] and contractual

159 It is interesting to notice the use of "his", see FC/WP2(57)2, Annex 2, and "he/it" in p.9.

160 Schön, Wolfgang, 'International Tax Coordination for a Second-Best World (Part I)', in 1 *World Tax Journal* 1, (2009), at pp.68-75.

161 Vann, for instance, has suggested that the rules on the existence of a permanent establishment are perhaps more appropriate to define corporate residence, see Vann, supra note 41, at pp.263-270.

162 The test focuses on legal concepts instead of economic activities, see Sadiq, Kerrie, 'Jurisdiction to tax and the case for threshold reform', in 1 *Journal of the Australasian Tax Teachers Association* 2 (2005), at p.173.

163 Ault, Hugh, 'Issues Related to the Identification and Characteristics of the Taxpayer', in 56 *Bulletin for International Taxation* 6 (2002), at p.263.

164 LON, E.F.S.73.F.19, at p.25[4029].

165 Vogel, supra note 6, n.10, at p.224.

166 Art.1 OECD Model Convention (2014)

167 The need to harmonise tax treaties was fundamental for the OEEC, see C(55)307, at p.2.

168 To fit the needs of a such a broad model, the term person was defined broadly in Art.3(1) OECD MC, see FC/WP14(60)1, at pp.2-3, and FC/WP14(62)2, at p.5. The definition needed to be as broad as Art.4 required, see FC/WP14(62)1, at p.3.

169 Art.3(1) letters a) and b) OECD Model Convention (2014). The final version of the definition of person was completed in 1962, see FC/M(62)1, at p.5.

170 This suggests that the conceptualisation of an entity as a 'person' would not be the real test to pass, see FC/WP14(62)1, at pp.1-6; and Hull, supra note 142, at p.55.

171 Helminen, Marjaana, 'Scope and Interpretation of the Nordic Multilateral Double Taxation Convention', in 61 *Bulletin for International Taxation* 1 (2007), at p.28.

172 De Boynes, Nicolas, 'France' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.454.

arrangements[174] as suitable candidates for tax treaty entitlement[175]. While in some cases the dividing line between the arrangement and its members is hard to draw, this raises the question of whether the Model requires the presence of a separate unit, different from its members, to be applied. It is relatively clear that if the laws of the States see an entity in any of these cases, there would be no obstacles in applying the OECD MC. However, if under the laws of these States a separate unit does not exist, the answer becomes less evident. It appears that the Model requires the existence of a 'person' or a 'body of persons', that is to say, a *body* identifiable on its own, different from its members, to be recognised by the laws of the State in which the claim is raised.

Vogel did not agree with this. In his opinion the "question whether a person […] may be a taxable entity under the law of the State concerned, is not a condition for treaty entitlement"[176]. While this may be the spirit of a definition based on the laws of the States, if any group of human beings were to be considered a 'person' for treaty purposes whenever they decide to claim its benefits, this would actually breach the manner in which domestic rules operate. After all, one needs to be a domestic resident to be a treaty resident. If the laws of a State do not even see *something* other than its alleged members it will hardly extend its tax authority over it. Perhaps Vogel was right in the sense that a group of persons ought not to necessarily create another legal entity in order to claim the benefits of the treaty collectively. Some States accept the ability of a contractual arrangement to generate a fictitious existence, a separate 'taxpayer', who is in fact subject to the tax authority of a State. If, for instance, a joint venture or any other agreement creates a submission to the authority of a State that is diverse from that of its members, then a person liable to tax for the purposes of the Model would exist. In other words, according to the Model, the 'liable to tax' condition must be tested to entities or agreements which are, under the laws of the different States, capable of generating the existence of a separate unit.

4.2.3. Taxable units: Bodies of persons and transparent entities

4.2.3.1. Bodies of persons in general

As was stated earlier, the fact that the Model refers to a *body* of persons and not to a *group* of persons suggests that an individual existence, separated from that of its members, is required for tax treaty purposes, even if it does not give place to a proper legal entity. However, there are further obstacles for treaty entitlement derived from the term 'resident of a contracting State'[177]. According to the Commentaries to the Model, it is possible to define a partnership or an association as a person[178], and yet this does not guarantee the availability of treaty benefits. The ultimate condition for using the Model lies in the consideration of an entity as 'liable to tax'. This idea was fairly clear when the rule was drafted:

> '[…] it is, however, not sufficient that a certain body of persons is considered to be covered solely by the term "person"; such body would also have to fulfil the requirements to be a "person resident in one of the Contracting States". The term "resident" of one of the Contracting States, however, requires that such body must be treated as a taxable unit in one of the Contracting States […]. A body of persons, which in itself is not liable to tax in any of the Contracting States concerned, might never be considered a person "resident in one of

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173 Schaffner, Jean, 'The OECD Report on the Application of Tax Treaties to Partnerships', 54 *Bulletin for International Taxation* 5 (2000), at p.219.
174 Vogel, supra note 6, n.29, at p.184.
175 This was in fact discussed during the history of the Model, see FC/WP2(57)2, at p.7; FC/WP14(61)2, at pp.4-7.
176 Vogel, supra note 6, n.24a, at p.229.
177 In fact, 'any person who is a resident' is a unity, see FC/WP14(61)2, at p.5. However, the key decision on tax treaty entitlement in enshrined in the definition of residence, see C(63)87 Part I, at p9. See also van Weeghel, supra note 133, at p.39.
178 Either a person or a body of persons, see Sec.2 of Comm. to Art.3 OECD Model Convention (2014).

> the Contracting States". Since such bodies may not be regarded as residents, it might, even for the application of the rules of allocation of taxation rights, not be harmful, were they only included within the term "person"'[179].

Under these guidelines, it is more or less clear that the ordinary meaning of the term 'liable to tax' requires, in addition to the presence of a *separate* unit, the necessity of a *taxable* unit for the treaty to operate. The imposition of this standard in relation to the treaty claimant is not so much of an issue in the case of an individual. While his consideration as a person in some manner reflects his very existence, the proof of his tax liability for treaty purposes refers specifically to his aptitude to be subject to the tax authority of a certain State. The case of an entity, however, is different. There may be entities which, despite having an individual existence, are not necessarily subject to this kind of authority.

By way of illustration, this would be the case if the laws of a State recognise a certain existence to a legal entity if one or more requirements for its creation are missing, and therefore the legal responsibility of its creators is established. In that case, although the entity exists and it is thus apt to be considered as a person under the Model, if the State would need to exercise its authority on it, its actions would nevertheless be directed against the persons who are behind its creation. In this sense, it is evident that the entity, although a person, would not be a *taxable unit*. A similar reasoning applies to a contractual arrangement. By entering into a contract (for instance a joint venture), although a legal entity is not necessarily created, the agreement in itself could generate a separate existence on which the tax authority of a State may be exercised[180]. If there was no agreement between the parties and they simply carried on business jointly, the State would no doubt exercise its tax authority over each of the participants. While in the first case there are reasons to accept that the contractual arrangement may generate the authority to claim treaty benefits, this would not be reasonable in the second case from the perspective of the Model. The need of a taxable unit implicit in the ordinary meaning of the term 'liable to tax' requires the presence of an entity that, in its own name and on its own behalf, may be subjugated to the tax authority of a State.

4.2.3.2. Transparent entities and partnerships: Potential tax liability

This analysis also pertains to the situation of transparent entities. As was stated earlier, Vogel disagreed with the idea that a partnership needs to be a separate taxable entity to access tax treaties. In his opinion, a flow-through entity 'should be considered a "resident", to the extent that its physical connection with the contracting State satisfies those criteria which, *if a tax liability existed*, would cause the organization to be taxable as a resident'[181]. According to Vogel, tax treaties prevent 'not only "current" but also merely "potential" double taxation'[182]. Given the fact that a transparent entity could eventually be turned into a taxable entity by a decision of the legislative authorities, there would always be the potential for the entity to be 'liable to tax', and this would justify its tax treaty entitlement.

Couzin uses the check-the-box regulations in the United States as an example to illustrate his disagreement with Vogel. By filing the corresponding form, an entity may decide to be disregarded for tax purposes (and therefore the partners will be subject to tax personally) or treated as a corporation (subject to tax at the level of the entity). The check-the-box rules, in other

[179] FC/WP14(61)2, at p.5.
[180] This is of course subject to the domestic laws of the contracting States on the matter.
[181] Emphasis added. See Vogel, supra note 6, n.25a, at p.95.
[182] See Vogel, supra note 6, n.46a, at p.28.

words, imply a potential tax liability upon election, and the transparent entity has complete dominion as to the moment at which it could acquire a non-transparent shape. In Couzin's opinion, that level of control 'lies beyond the scope of the inquiry relevant to the application of the "liable to tax" test'[183], because the meaning of this expression "is not entirely without limits"[184]. Before the box has been checked no entity really exists for tax purposes and the only *visible* persons are the members of that entity, who may be subjugated to the tax authority of that State. In line with Couzin's thoughts, it is relatively clear that the Commentaries require the existence of at least a separate 'presence', and therefore reject the idea of a wholly potential liability to tax as an argument for treaty entitlement in cases of flow-through entities:

> 'Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the Conventions concluded by the States of which they are residents.'[185]

The reasoning behind this provision is fairly simple: tax treaty entitlement needs to be claimed by somebody, and such a person needs to exist for tax purposes. This is in no way different from the conceptualisation of residence at the domestic level. If there was a partnership in a State that accepts its separate existence, then that State would exercise its tax authority over the partnership directly. On the contrary, if the State does not see a separate entity, it would be absurd to expect that such State would exercise its tax authority over something that simply does not exist. The same applies in the case of treaty benefits. If there was a *body* of persons, subject to the tax authority of a State, being assessed, filing tax returns and declaring or paying taxes, one would understand if such an entity has the ability to use treaty benefits, deductions or allowances. If not, then logically that ability would have to correspond to someone else, in this case its members.

Vogel, however, was right when he pointed out that it is not the legal form of the entity that matters for treaty purposes[186]. The fundamental element one needs to keep in mind is the tax treatment the entity is subject to in the State in which it is created[187]. In relation to partnerships, the Commentaries to Art.1 OECD MC add:

> "Where a partnership is treated as a company *or taxed in the same way*, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention"[188].

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183 See Couzin, supra note 20, at pp.120-121.

184 See Couzin, supra note 20, at p.117. Moreover, in his opinion 'it is not reasonable to assume that the contracting states would have intended the potentiality implied in the "liable to tax" requirement to go this far', see Couzin, supra note 20, at p.118.

185 Sec.8.8 of Comm. to Art.4 OECD Model Convention (2014). This finds support in other sections of the Commentaries: if 'a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State', see Sec.5 of Comm. to Art.1 OECD Model Convention (2014); and "a fiscally transparent CIV would not be treated as a resident [...] because it is not liable to tax", see Sec. 6.11 of OECD Comm. to Art.1 OECD Model Convention (2014).

186 Vogel, supra note 6, at p.95.

187 Something that is highly relevant for the purposes of structures such as CIV, see Barret, Edward, 'Aspects of the 2010 Update Other than Those Relating to Article 7 of the OECD Model Tax Convention', in 65 *Bulletin for International Taxation* 1 (2011), at p.14; and funds in general, see Lawless, David, et al., 'Taxation of Collective Investment Funds and Availability of Treaty Benefits', in 50 *European Taxation* 2 (2010), at pp.54-55.

188 Emphasis added. Sec.5 of Comm. to Art.1 OECD Model Convention (2014).

If a partnership is taxed *as a company* that means that the partnership is not only a separate legal entity, but it also means that it is a taxable unit, in the sense that the authority of the State will be exercised in its respect. Such entity is certainly 'liable to tax'. In the less straightforward scenario in which the partnership is *taxed in the same way* as a corporation, the situation does not seem to change, at least from the perspective of the partnership's tax liability. The fact that such an entity is taxed as if it were a company cannot but imply that the partnership is treated as a separate unit, diverse from its partners, for this is the way in which companies are taxed. In plain terms, the Model leaves the door open to cases of arrangements that are not capable of creating a separate legal existence, if they are taxed as such, with independence from its members.

Problems of course arise, as is customary, in the intermediate cases. There may be scenarios in which some attributes related to the tax liability of an entity are shared between the entity and its members. France, for instance, considers partnerships as having a separate tax personality, but the income they generate is taxable directly and proportionately in the hands of its partners[189]. The tax due is calculated at the partnership level but it is imposed on its members. If the OECD's explanations are followed, there may be reasons to believe that the persons entitled to treaty benefits should be the partners, as they seem to be the ones over whom the tax authority of France is extended. France, however, disagrees with this reasoning[190], and it considers that the partnership is 'liable to tax', and it should therefore be entitled to claim the benefits of the Model directly. Yet the problem seems to arise immediately after the laws of France have determined that the subject on whom its tax authority may be applied is the partner. As a consequence of these laws, and despite the much more complex question of attribution of income in such cases[191], the partnership may be recognised as a person for the purposes of the Model, but it may hardly constitute a taxable unit according to the ordinary meaning of the term 'liable to tax'.

4.2.3.3. Securing treaty benefits in cases of transparency

To some scholars the issue of transparency appears to be one of effective liability to corporate income tax[192]. In other words, if taxes are collected (whether in the hands of the partnership or of the partners) the benefits of a treaty should be available. However, for the benefits of a tax treaty to be obtained the 'liable to tax' condition must be fulfilled in very precise terms: it is the entity that needs to be 'liable to tax'. Some courts have nonetheless granted treaty benefits based on the taxation of the income involved in the claim, thus indirectly recognising treaty entitlement to a transparent entity.

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189 See France, Conseil d'Etat, 9/8 SSR, 4 April 1997, case number 144211: "[…] que les groupements d'intérêt économique (GIE), qui, en vertu de l'ordonnance du 23 septembre 1967, ont une personnalité distincte de celle de leurs membres, exercent, conformément à leur objet et dans les limites fixées par leurs statuts, une activité qui leur est propre; que, dans la mesure où les actes correspondant à cette activité sont effectués en France, les bénéfices en découlant sont imposables en France entre les mains des membres du groupement, à proportion, pour chacun, des droits qu'il détient dans ce dernier, y compris de ceux qui résident hors de France, sauf stipulation contraire d'une convention internationale relative aux doubles impositions […]".

190 France has put a reservation to Art.4 OECD MC: 'France does not agree with the general principle according to which if tax owed by a partnership is determined on the basis of the personal characteristics of the partners, these partners are entitled to the benefits of tax conventions entered into by the States of which they are residents as regards income that "flows-through" that partnership.'

191 A question that has been extensively explored by Wheeler, supra note 11.

192 Vogel, Klaus, 'Tax Treaty News', in 59 *Bulletin for International Taxation* 10 (2001), at p.91; Lehérissel, Hervé, 'France: The Tax Residence of Companies', in 39 *European Taxation* 4 (1999), at p.159.

In the Diebold case[193], a French company was assessed because it did not withhold taxes on royalties paid to a Dutch transparent entity. The Supreme Court of France reversed this decision, based on the fact that the royalties were taxed in the hands of a resident of the Netherlands. This occurred despite the fact that such resident was not the partnership itself but its partners[194]. Likewise, in the TD Securities case[195], a United States limited liability company (LLC), fully owned by another US company, had a branch in Canada. The Canadian tax authorities denied the reduced rate of branch tax provided in the treaty, because the LLC was transparent for US domestic purposes. As in the Diebold case, the Canadian court reversed this decision by stating that treaty entitlement ought to be recognised because the income was taxed in the US, although not in the hands of the LLC, but on the hands of its parent. Something similar happened in the Linklaters case[196], where a UK transparent partnership was considered to be 'liable to tax' by an Indian court because its income was taxed in the UK in the hands of its partner.

If one were to conclude that tax treaty entitlement was granted, in these cases, only because the relevant income was taxed by the State where treaty benefits were claimed, these decisions would not adjust to the ordinary meaning of the term 'liable to tax'. Under Art.4 OECD MC, tax liability is an attribute of persons. On the contrary, in an attempt to secure the benefits of the treaty, these courts waived the structure of the provision by testing the liability to tax on the income these persons received. It would have been different if, in those particular cases, the relevant courts analysed the tax liability of the person to whom the income was, at the outset, attributed (i.e. the partners). In such a case one may agree that, beyond any discrepancies as to the way in which the laws of a State or the Model attribute any given flow of income, the logic behind Art.4 OECD MC would have been respected.

While the conclusions arrived at by the courts appear to be appropriate inasmuch as double taxation was finally avoided, treaty entitlement was conferred because the income was taxed in the hands of a resident of the relevant State, and not because the treaty claimant (the transparent entity), was 'liable to tax'[197]. It was that entity or, at the very least, the partners, that had to be qualified as 'liable to tax' for the treaty to operate but, as the courts acknowledged, theoretically, the transparent entity was not 'liable to tax' at all.

4.3. The role of income in defining tax liability

On the face of it, tax liability represents a relation of authority between a person and a State. Considering that this is the way in which domestic law normally defines residence, the situation could not have been different. Yet a crucial effect arises from this configuration: the exclusive

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193 *Diebold* case, supra note 10. For some historic background on the case see Baranger, Severine, 'New Guideline on Recognition of Transparency Principle for Foreign Partnerships', 47 *European Taxation* 8 (2007), at pp.420-423.

194 The text of the French Supreme Court ruling in its original version states "que si Equilease CV est une société en commandite, dépourvue de personnalité juridique et fiscalement transparente en droit néerlandais, son commandité, la société Equilease Management BV, et son commanditaire, la société Crediet en Discount BV étaient assujetties à l'impôt en Hollande et avaient la qualité de résident des Pays-Bas au sens de la convention susvisée, pendant les années 1983 et 1984; que, par suite, les redevances versées à Equilease CV pendant les années en cause, qui, compte tenu du statut de cette société, doivent être réputées versées à ses associés, satisfaisaient donc en principe à la condition de paiement à un résident des Pays-Bas, exigée par l'article 12 de la même convention pour réserver aux Pays-Bas l'imposition desdites redevances", see *Diebold*, supra note 10.

195 Tax Court Canada, 08 April 2010, *TD Securities (USA) v. Her Majesty the Queen*, (2010) TCC 186.

196 *Linklaters*, supra note10.

197 As Wheeler rightly points out when explaining her approach on the OECD MC, if the treaty had been drafted differently, the judge could have reached the same conclusion without violating its wording, see Wheeler, supra note 11, at p. 339.

focus on the person entails, as has been stated earlier, the need to disregard the situation of the income when analysing the appropriateness of a treaty claim.

As early as in 1967, the Delegation for Belgium was struggling with the situation of fiscally transparent entities. At their election, Belgium partnerships could be taxed directly on their profits, or also in the hands of the partners. In the second case, however, although the partnership had legal personality and all the profits were taxed in Belgium, the conditions imposed by Art.4 OECD MC were not met, because the partnership was not 'liable to tax' in itself. The Delegation for Belgium therefore proposed that the definition of residence should be amended in order to state that the term 'resident of a contracting State':

> "...means any person *whose income or capital* is, under the law of that State, liable to taxation therein, by reason of his domicile, [...]"[198]

In cases of transparency, this suggestion gave place to a proposal:

> 'a) Income from sources in one Contracting State which is included in the income which is also taxed in the other State [...] should be treated as if it were received by person resident in that other State. Such a rule would be necessary whether or not the Contracting States apply the same approach in the treatment of partnership-income. [...]
>
> This means:
> 1. Where the partnership is taxed in the State in which it is "established" from world-wide income (subject to unlimited tax-liability, domiciled within the meaning of Article 4 par. 1), income received by such partnership should be treated in both Contracting States as income received by a resident of the State in which the partnership has been established.'[199]

While this would support Vogel's views as to the existence of a body of persons even in the absence of a separate entity, Couzin has explained the consequences of the term 'liable to tax' referring to the person and not to the income[200]. Treaty benefits cannot be expected to be recognised in the hands of a person other than the person who is to be considered as 'liable to tax' according to the Model. It is irrelevant whether the income is 'liable to tax' because it is the person that needs to be so characterised. On the basis of this idea, Wheeler proposed a whole new version of the OECD MC[201], which is essentially based on the proposal by the Delegation for Belgium.

In very simplified terms, Wheeler explains that the absence of any mention of the income in Art.4 OECD MC creates all sorts of mismatches leading to an inconsistent application of tax treaties[202]. In the example by the Delegation of Belgium, also used by Wheeler on several occasions, there would be hardly any doubt that treaty access should be granted in the case of such transparent entity. This would occur because tax liability would have to be verified on the basis of the relevant income, and not in relation to the person itself. On the contrary, the OECD's approach, by testing tax liability in the hands of the person (and disregarding the situation of the income), restricts the application of the Model. One needs to understand, however, that this is but an effect of the need to follow the provisions of domestic law on residence. In fact, no State considers the situation of the income when making a decision on domestic residence.

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198 Emphasis added. TFD/FC/216, at p.6.
199 Emphasis added, see CFA/WP1(75)2, at pp.22-23.
200 Couzin, supra note 20, at p.109.
201 Wheeler has brilliantly considered the issue of attribution of income from the perspective of Art.4 OECD MC to propose a new version of the OECD MC. See Wheeler, supra note 11.
202 Danon arrived to a similar conclusion in the field of trusts, see Danon, Robert, 'Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report', in 32 *Intertax* 5 (2004), at p.222.

The merit in the Belgian proposal, further developed by Couzin and Wheeler, lies essentially in demonstrating that a domestic configuration of residence poses several obstacles for the application of tax treaties. Moreover, it answers several questions in the field of attribution of income such as transparency[203], timing mismatches[204], fragmented tax liability[205], persons acting in different capacities, amongst others. Further, it provides an alternative to give consistency to the construction of the term 'liable to tax' in both contracting States. The approach, however, has identified the need to consider the income on the premise that the OECD MC must only operate in scenarios of effective double taxation[206], something that is highly debatable from a policy perspective and considering the rules of the Model itself. It is relatively clear that the consideration of income in Art.4 OECD MC will render the definition of residence even narrower[207], and therefore some valuable results from the standpoint of policy (such as the treaty entitlement of tax-exempt entities) would be impossible[208]. It is also clear that some States enter into treaties to achieve certain policy objectives that may or may not require taxation in its counterparty, such as capital-import neutrality. It is rather doubtful whether those States will be willing to adopt this new model.

4.4. Evaluation: Residence as an attribute of non-transparent persons

Long before the OECD even came to exist, the test of residence was designed to describe an allegiance between a person and a certain State. While in principle the analysis of this link was limited to the case of individuals, the rise of separate legal entities brought up the need to discuss the basis of their allegiance as well. Instead of dealing with the issue in a separate manner, a strategy was followed to treat these entities as if they were individuals, and to judge their allegiance with the States on the basis of equivalent factors. Nowadays, this implies that the analysis of whether individuals or entities may be considered to be residents needs to be based on the same fundamental considerations.

The OECD MC follows the historical construction of the term 'resident' by defining the term 'liable to tax' as an attribute of individuals and entities that are either treated as a company or at least *taxed* as such. This crucial standard imposed by the ordinary meaning of the term implies that, irrespective of the precise legal form used, in order to access the Model the treaty claimant needs at least to be treated for tax purposes as if it were a separate person, different from its members. Moreover, the meaning of the term not only requires a separate entity but it also requires a taxable entity, on which the authority of the State in which treaty benefits are claimed may even potentially be applied.

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203 See effect of Wheeler's approach in the *Bayfine* case, Wheeler, supra note 11, at pp.131-133; and in the *Padmore* case, at pp.123-125.

204 See effect of Wheeler's approach in the *Smallwood* case, Wheeler, supra note 11, at pp.125-131.

205 Wheeler, supra note 11, at pp.135-144.

206 Wheeler considers tax liability on income as a means to provide tax treaty entitlement. This idea imposes the need either to deny the benefits of a treaty in cases of artificial ownership (an alternative that she finds harsh), or to grant treaty entitlement only on income that is effectively taxed, see Wheeler, supra note 11, at p.103. Further, at p.82 Wheeler clarifies that this naturally results in the need to modify her new approach in States using treaties only for the allocation of tax jurisdiction.

207 See supra, Chapter 2; and Vogel, supra note 25, at p.418.

208 Unless an exception to the rule is established. See the proposal made by de Graaf, A., and Pötgens, F, 'Worrying Interpretation of "Liable to Tax: OECD Clarification Would Be Welcome', in 39 *Intertax* 4 (2011), at pp.176-177; Ault, supra note 163; Helminen, supra note 171, at p.34; Galea, Rachel, 'The Meaning of "Liable to Tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation', in 66 *Bulletin for International Taxation* 6 (2012).

In concrete terms, this suggests that while bodies of persons or contractual arrangements having a separate existence may be qualified as residents under the Model, an entity which under domestic law is fully transparent does not meet the standards imposed by the meaning of the term 'liable to tax' to access its benefits. This should not be striking, however, since under domestic law a separate taxable entity is commonly required for the State to even consider extending its tax jurisdiction over such an entity. The problem is that the Commentaries state that no standards are imposed on domestic residents to access the benefits of the Model. Arguably, it is this statement which has led authors like Vogel to believe that transparent entities should be entitled to treaty benefits, because the decision of potentially extending a State's tax authority over such an entity (if it can be called that way) forms part of that State's sovereign prerogatives.

The fact that a transparent entity may potentially be subject to the tax authority of a State because of a change in its laws or any other equivalent event, however, greatly exceeds the boundaries the Model imposes. That tax liability would be, in simple words, *too potential*. Domestic rules may not necessarily need a separate entity to be a taxable unit, as has been argued in the case of France, to define a tax liability. Yet, it is relatively clear that the ordinary meaning of 'liable to tax' in the Model does, for the purposes of being able to claim its benefits.

This may be the reason why some courts have been reluctant to recognise the tax liability of a group of multinational enterprises subject to a regime of consolidation. Although for certain purposes that group may be treated as a fiscal unity, this cannot imply that the group itself constitutes a *body* of persons[209], unless of course the laws of the relevant State so declares. Not every group of individuals and entities may be able to claim the benefits of the OECD MC, but only one that is a separate and taxable unit within one of the contracting States. After all, someone needs to be subject to the tax authority of the State in which treaty benefits are claimed.

Despite the fact that in certain scenarios (such as in cases of transparency) it may be tempting to look at the situation of the income when studying whether a tax treaty must be applied, such an approach would not be consistent with the text of the Model. This occurs because the 'liable to tax' requirement sets a standard which is essentially subjective, that is, focused on the situation of the person claiming treaty benefits, and not on the income received by this person. This aspect of the definition, underpinned by the Delegation for Belgium as early as in 1967, and largely developed by Couzin and Wheeler, is fundamental when attributing its meaning to the term 'liable to tax'. As a matter of fact, as Wheeler so gracefully observed, the possibility to sustain a different interpretation of the Model would require the rule of residence to be drafted in a sensibly different manner.

[209] Supreme Court of the Netherlands, 3 February 2012, *cases number 10/05383*, *10/05385* and *10/05386*, commented by Hans Mooij, IBFD Tax Treaty case law.

5. Chapter 5
Tax liability by reason of a connecting factor

5.1. Residence must arise 'by reason of' a connecting factor

In addition to the existence of a subjective tax liability under the laws of the State of residence, Art.4 OECD MC requires such tax liability to arise 'by reason of' certain criteria, exemplified in the rule. The examples used (domicile, residence and place of management) have led some authors to believe that the Model should be applied only where a link of a certain magnitude exists between the claimant and the alleged State of residence. Vogel, for instance, was of the opinion that the criteria mentioned in the definition illustrated the necessity of a 'locality-related attachment'[210], thus capable of excluding factors such as nationality or incorporation. In the Crown Forest case, the Supreme Court of Canada had to deal with the fact that the lower courts had determined that a company (Norsk) was a resident of the US under Art.4 of the US-Canada treaty, by reason of having a place of management and/or[211] a place of trade or business in the US. This however occurred despite the fact that Norsk was treated as a non-resident therein.

The definition of residence in Art.4 OECD MC allows one to raise two fundamental questions in this particular field. On the one hand, by reason of which factors must one person be 'liable to tax' in a State for the benefits of the Model to apply; and on the other hand, whether a qualified nexus (for instance a locality-related attachment) may be required for the benefits of the Model to be granted, as an effect of the examples used in Art.4 OECD MC. As was stated before, from a general perspective the use of the expression 'by reason of' in Art.4 OECD MC raises the question of whether the particular connecting factors mentioned in the rule have implications when defining tax liability, and thus when making a decision as to the applicability of the Model.

Moreover, this part of the definition is also relevant if one considers that there may be other factors which, being of a *similar nature*, may result in the application of the Model as well. By way of illustration, this may occur in the case of incorporation, nationality, or even source taxation, amongst other elements that will be explored subsequently[212]. Similarity in nature is, however, not a very clear notion, and therefore its analysis is crucial to understand the scope of application of tax treaties. Lastly, the need not to exclude residents from States applying the territorial system of taxation from the scope of the OECD MC, clearly expressed in the Commentaries, cannot be forgotten. There is little clarity as to the possibility of sustaining this interpretation of Art.4 OECD MC, given the conceptualisation of the connecting factors made by the OECD.

5.2. Connecting factors in Art.4 (1) OECD MC

5.2.1. The relevant connecting factors in the history of the Model

The relevance of the connecting criteria mentioned in the definition of residence seems to be provided by the use of the phrase 'by reason of'. This expression denotes "the existence of some sort of causal connection, or, in the least, some relationship of proximity"[213] between the

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[210] Vogel, supra note 6, at p.233.

[211] The Federal Court Trial Division accepted both arguments, whereas the Court of Appeal considered that Norsk was a resident in the US not because of having its place of management, but only as a consequence of being engaged in trade or business therein, see *Crown Forest*, supra note 13, at pp.810-811.

[212] Factors such as these will be analysed in the following sections, see infra Chapter 5, at p.57.

[213] *Crown Forest*, supra note 13, at p.815.

connecting factors in Art.4 OECD MC and the tax liability required for the Model to apply[214]. It seems, in other words, that the application of the Model depends on one of those factors[215] being capable of triggering a tax liability from a personal perspective[216] at a certain point in time[217]. The undeniable relevance of the connecting criteria, seen in the abstract, is nonetheless often attributed to the particular factors mentioned in the rule (domicile, residence and place of management). In other words, at times it appears that it is not the relation of causality that matters for the purposes of analysing Art.4 OECD MC, but the particular examples mentioned in the rule, to define the tax liability that would properly cause the application of the Model.

Much has been said in relation to the connecting factors mentioned in Art.4 OECD MC. As a matter of fact, different authors have extracted important conclusions from the criteria mentioned in relation to the definition of residence. It has been argued, for instance, that the criteria in Art.4 OECD MC describe a locality-related attachment that, consequently, would exclude certain elements such as nationality or incorporation[218]. It has also been said that they describe the most comprehensive tax liability imposed by a State[219]; that they ensure that only those who have a "sufficient local connection"[220] or a "market-economy connecting factor"[221] may enjoy treaty benefits, and so on. A quick review of the history of Art.4 OECD MC, however, may be very enlightening by way of introduction to the true significance of the connecting factors mentioned in the Model.

According to the first draft of Art.4 OECD MC presented by the Delegation of Switzerland, tax liability was to be ascertained under internal law, by reason of domicile, head office, residence, or by reason of any other similar criterion[222]. The fact that this draft referred to those particular connecting factors was not a coincidence, but a reflection of the general rules of residence followed by the domestic laws of Switzerland at that time[223].

The intention behind the proposal, however, was not to restrict the rule to those domestic factors, but only to use them as examples. In fact, when exploring the effect of tax treaties, the Swiss Delegation explained:

> "Such Conventions apportion between the two contracting States in accordance with certain criteria (known as criteria of attachment, such as domicile, location, place of employment, source), the right to tax […]"[224].

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214 According to Couzin, "[o]n a plain reading of [Art.4 OECD MC], it is not sufficient that a corporation be both resident in a contracting state and liable to tax in that state in order to be a resident of the state for purposes of the convention. There must also be a causal link between the liability to tax and one of the prescribed connecting factors: residence, place of management or any other criterion of a similar nature", see Couzin, supra note 20, at p.130.

215 Brooks, supra note 127, at p.426.

216 Rust, Alexander, 'Germany' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.378.

217 Lemos, Marika, 'United Kingdom' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at pp.618-619; see also *Smallwood*, supra note 18.

218 Vogel, supra note 6, at p.233.

219 *Crown Forest*, supra note 13, at p.821.

220 Widrig, supra note 14, at p.286.

221 Jung, supra note 14, at p.233.

222 FC/WP2(57)2, at p.9. This was the first formulation of the connecting factors in the history of the OECD MC.

223 The connecting factors in Switzerland remain the same today. For individuals see Obrist, T. and Pfister, R., 'Switzerland' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at pp.542-545; and for companies see Maraia, J.F., 'Switzerland' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at pp.803-804.

224 FC/WP2(57)2, at p.5.

Having accepted the Swiss formula, Working Party 2 nevertheless made it clear that the enunciation of the connecting factors at the domestic level required a broader approach. Accordingly, it stated:

> 'Where the term "fully liable to taxation" is used, a supplementary reference has been put in the amended draft to the effect that this liability to tax must have its basis in the provisions on domicile, residence, headquarters, nationality or some other similar criterion in the internal fiscal law of the Member countries.
>
> [...] In framing its draft the Working Party has chosen the "direct" method of laying down at the beginning of the Article a rule that the right to tax belongs to the State where the person concerned is fully liable to tax by reason of domicile, *etc.*, unless otherwise provided in the special articles of the Agreement."[225]

Moreover, in the following report, while defining the term resident, it was stated:

> '[...] it would be necessary to say: "the State in which he is liable to taxation by reason of domicile, residence, *etc.*"[226]

The final proposal submitted to the Fiscal Committee adopted a different form:

> "For the purposes of this Convention, the expression "resident" of a State means any person who, under the national law of that State, is liable to taxation therein by reason of his domicile, residence, head office, nationality or some other similar personal criterion."[227]

In its last version, however, the draft rule was changed again, but the reasons were not stated:

> 'After an exchange of views, the Committee decided to use the term "resident" in the French text, as in the English text, and to commence the Draft Article with the following definition of the term "resident":
>
> "For the purposes of this Convention, the expression "resident" of a State means any person who, under the national law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other similar criterion."'[228]

Regrettably, the views that led to the final draft of the rule, which is the closest version to the current Art.4 OECD MC, were not expressed in the records of the Working Party. What seems to be clear, however, is that the use of domicile and residence resulted as a consequence of their widespread adoption in the domestic laws of the different States at that time.

The inclusion of the 'place of management' criterion may have responded to the simultaneous discussions held at Working Party 8 in relation to the rule on income from shipping and air transportation which, in fact, was intimately connected with the work of Working Party 2[229]. Likewise, the inclusion may have been influenced by the discussions held at Working Party 1 which, at that time, was studying the definition of permanent establishment for treaty purposes[230]. It is nonetheless clear that the final drafting of the rule did not respond to any reason in particular. The addition of 'any other similar criterion' seems to have waived the need to list every possible criteria of attachment considered by the domestic laws of the different States.

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[225] Emphasis added, FC/WP2(57)2, at pp.2-3.
[226] FC/WP2(57)3, at p.6.
[227] TFD/FC/27, at p.1.
[228] FC/M(58)I, at p.3.
[229] See FC/WP5(57)2, at pp.13-15; FC/WP6(57)1, at pp.1-3; FC(58)4, at pp.2-3; and mainly FC/WP12(58)1, at pp.1-4.
[230] Vann attributes the inclusion of the place of management to the interaction with Working Party 1, see Vann, supra note 41, at pp.233-234.

Consequently, when the argument is raised that the intention of the OECD was to restrict the list only to certain criteria of attachment, capable of giving place to residence under specific circumstances, it seems that the history of the Model speaks for itself. The particular enumeration of connecting factors in the Model was never a concern to the OECD. The use of domicile, head office, residence, location, place of employment, nationality, place of management, source and, more importantly, the use of *etc.* on more than one occasion, strongly suggests that there was no intention whatsoever to restrict in any manner the ability of domestic factors to create residence for treaty purposes.

In fact, the OECD neither restricted the list, nor did it include any references as to the source for a definition of the terms contained in it. While to some, "there are several reasons why the redefinition of these words in Article 4(1) should not be completely at the whim of each contracting State"[231], according to the history of the Model, that was precisely the idea. These terms only serve as an example, and those examples "must be interpreted by reference to domestic law"[232]. In fact, ignoring the strict domestic conceptualisation of these terms carries the risk of excluding certain domestic forms of attachment[233], which is not the intention behind the Model.

The history of the connecting factors clarifies that the use of a certain terminology in Art.4 OECD MC was not a thorough decision, at least not in terms of sending a message for the purposes of the interpretation of treaties, or setting out standards for domestic residents to access their benefits. The use of connecting criteria during the process of drafting Art.4 OECD MC was entirely random, and the number of expressions used was only reduced to the prevalent terms at that time, followed by a catch-all rule, such as 'any other similar criterion'. Irrespective of the specific nomenclature used by the domestic laws of the contracting States, any term contemplated in those laws, capable of giving place to a subjective tax liability in that State, should be apt to generate residence for the purposes of the OECD MC.

5.2.2. Domicile, residence, place of management, incorporation and *etc*.

Bearing in mind that the verification of the conditions under which a person may be said to be a resident of a State is initially left to the domestic laws of the States, the nomenclature used may vary from State to State. As has been stated earlier, however, the particular terms used are immaterial, inasmuch as they can create tax liability at the domestic level. It is worth reiterating, though, that if the laws of a State consider a person to be a non-resident for domestic purposes, there is no possible construction of Art.4 OECD MC leading to the conclusion that such person is a resident for treaty purposes. If the person is not a resident of that State to begin with, a tax treaty cannot artificially create that status.

In the Crown Forest case, Norsk was non-resident company for US tax purposes and, nonetheless, two different courts in Canada declared that the company was a resident in the US on the basis of the provisions of the US-Canada tax treaty. Norsk, under the reasoning of the courts, was a resident in the US because it maintained a place of management therein, as stated in the treaty, or because it was engaged in trade or business in the US, which was found to be equivalent to other criterion of a similar nature. Norsk, however, was indisputably subject to the rules of taxation of non-residents in the US[234].

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[231] Couzin, supra note 20, at pp.134-135.
[232] Vogel, supra note 6, at p.230.
[233] Rust, supra note 216, at p.376.
[234] Norsk was liable to tax only in relation to the income attributable to the trade or business in the US.

The principle that there cannot be treaty residence without domestic residence implies that an interpretation of tax treaties creating residence only on the basis of a treaty provision, regardless of residence at the domestic level, would be incorrect. It also implies that, each time residence is analysed for the purposes of the Model, the point of departure is, unavoidably, in the domestic laws of the State of residence. The primary consideration of these laws means that the States are left free to describe the factual conditions that would lead a person to be a resident for domestic purposes, and the interpretation of treaties must be made bearing that in mind. The relevance of this lies in the fact that the processes through which the States build up their definitions respond to their own domestic reality.

States have in fact employed a variety of terms to define the extent to which their tax jurisdiction will be exercised. They have used criteria such as incorporation[235], registered office[236], seat[237], nationality, domicile[238], place of management[239], habitual abode[240], a stay of a certain length[241], or even formal mechanisms, as the check-the-box regulations in the US. Further, other less traditional tests have been included at the domestic level, such as the voting power control test[242], the main object of their business[243] test, open tests such as the 'all-facts-and-circumstances' test[244] for companies and individuals[245], the 'organized under the laws of one of the United States'[246] test, the Commonwealth superannuation test[247], the seat of wealth[248] test, and many others.

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235 Australia, in relation to companies see Dirkis, supra note 83, at p.318; Canada, see Brooks, supra note 127, at pp.415-417; Germany, see Englisch, supra note 102, at pp.479-482; the Netherlands, see de Boer, supra note 141, at pp.574-576; South Africa, see Hattingh, Johann, 'South Africa' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.679; Spain, see Martinez Giner, L., 'Spain' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.765; United Kingdom, see HJI Panayi, supra note 126, at p.825; United States, see Brauner, supra note 111, at p.865.

236 Spain, see Martinez Giner, supra note 235, at p.766; Switzerland, see Maraia, supra note 223, at pp.802-803.

237 Austria, see Simader, supra note 118, at pp.350-351; Italy, see Tenore, Mario, 'Italy' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.531.

238 Australia, with reference to individuals see Dirkis, supra note 83, at p.208; Austria, see Daurer, Veronika, 'Austria' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.248; Belgium, see Bellens, Aagje, 'Belgium' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.281; France, see Message, Nicolas, 'France', (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.337; Germany, see Rust, supra note 216, at p.367; United Kingdom, see Lemos, supra note 217, at pp.597-598.

239 Considering management in general: Australia, with reference to companies see Dirkis, supra note 83, at p.319; centre of business direction in Austria, see Simader, supra note 118, at pp.351-352; Canada, see Brooks, supra note 127, at pp.413-415; Italy, see Tenore, supra note 237, at p.531; Netherlands, see de Boer, supra note 141, at pp.562-573; South Africa, see Hattingh, supra note 235, at p.679; Spain, see Martinez Giner, supra note 235, at p.766.; Switzerland, see Maraia, supra note 223, at p.802; United Kingdom, see HJI Panayi, supra note 126, at p.825.

240 Austria, see Daurer, supra note 238, at p.248; combining permanent home and principal abode in France, see Message, supra note 238, at pp.338-339; Germany, see Rust, supra note 216, at p.367; habitual residence in Spain, see Nuñez Grañon, Mercedes, 'Spain' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at pp. 513-514.

241 The 183-day in Australia in relation to individuals, see Dirkis, supra note 83, at p.208; and the stay exceeding six months in Norway, see Hveding, S., and Backer-Grøndahl, F., 'The concept of Residence for Tax Purposes in Norway', in 56 *Bulletin for International Taxation* 8 (2002), at p.428.

242 Australia, in relation to companies see Dirkis, supra note 83, at p.324.

243 Italy, see Tenore, supra note 237, at p.531.

244 Netherlands, see de Boer, supra note 141, at p.561; a similar test is applied in Canada for the determination of residence of individuals, see Brooks, Kim, 'Canada' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at pp.305-310.

245 Netherlands, see Gunn, Anna, 'Netherlands' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.470.

246 United States, see Brauner, supra note 111, at p.865.

247 Australia, for companies see Dirkis, supra note 83, at pp.219-220.

The terms used as an illustration in Art.4 OECD MC do not set any limits in relation to the particular terms that the States may use to define tax liability for domestic purposes[249]. Each State is left free to use any terminology so as to determine the extent of its tax sovereignty. Such a realisation therefore renders any attempt at finding the meaning of the terms domicile, residence and place of management used in Art.4 OECD MC meaningless. In principle, any factor that is capable of producing tax liability according to this rule, at the domestic level, should result in the generation of residence for treaty purposes. This would occur either because the company has its residence in the respective State, or, in general, because of the presence of any other criterion of a similar nature.

The key, however, is in the appreciation of those factors domestically and not from the perspective of the treaty. Using, once more, the example of the Crown Forest case, even if Norsk had a place of management in the US, and the place of management was one of the connecting factors mentioned in Art.4 of the US-Canada tax treaty, that could not have rendered Norsk a resident in the US. The reason for this is simple: under the internal laws of the US, a company cannot achieve the domestic status of resident merely by having a place of management therein[250]. If Norsk had been located in Italy, for instance, the situation may have been different, because companies having a place of management in Italy can be considered to be residents in Italy for domestic purposes[251].

It is worth mentioning that if the States envisage a broad concept of residence under their laws, capable of encompassing one or more of the above mentioned criteria, those persons would have access to the treaty on account of their status of residents, and not on occasion of the specific factor that gave place to residence at the domestic level. In other words, if, for instance, a State decides to employ the place of incorporation as a criterion of residence at the domestic level, that company will be granted access to tax treaties in its status as a resident of that State. There would be no need to demonstrate that incorporation is a criterion of a similar nature[252]. The same holds true for any other case in which the residence of a person is deemed to be in a certain State[253].

The list of connecting factors mentioned in the Model bears no significance for the purposes of restricting the scope of the treaty. In fact, reading too much in that list of examples introduces obstacles for an appreciation of the main rule behind the definition of residence: the connecting factors giving place to tax liability are of the exclusive competence of the domestic law of the States. Cases such as incorporation, check-the-box, nationality, deemed residence and equivalent situations are normally criticised due to the low level of economic connection that they require between the treaty claimant and the respective State. However, one needs to assume that this is

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248 Belgium, see Bellens, supra note 238, at p.281.

249 Delattre, Olivier, supra note 125, at p.208.

250 *Crown Forest*, supra note 13, at p.819. See in particular the mention to Michael Edwardes-Ker who criticises the ruling of the Federal Court Trial Division on these grounds.

251 A place of management in Italy gives place to corporate residence, see Bizioli, Gianluigi, 'The Evolution of the Concept of the Place of Management in Italian Case Law and Legislation: Interaction with Tax Treaties and EC Law', in 48 *European Taxation* 10 (2008), at pp.527-530.

252 Couzin, see supra note 20, at p.138. The US and Canada use incorporation as a criterion for residence and thus they have entered into reservations to Art.4 OECD MC, see Widrig, supra note 14, at p.282. Chile, which became an OECD Member in 2010, also uses incorporation as a criterion of domestic residence. The fact that Chile has not entered any reservations to the rule does not exclude the fact that companies incorporated in Chile are residents both for domestic and tax treaty purposes. The same holds true in the Netherlands, where a company incorporated is a resident not because of the application of a criteria of a similar nature, but because of its consideration as a resident, see de Boer, supra note 141, at p.590.

253 See Gunn, supra note 245, at p.481.

the manner in which Art.4 OECD MC operates and, perhaps more importantly, the consequences that, for the purposes of applying tax treaties, this entails. The meaning of treaty residence is, ultimately, a matter of national sovereignty.

5.2.3. The use of 'any other criterion of a similar nature'

5.2.3.1. Any other criteria under domestic law

Every time a treaty claim is raised, the laws of the State of residence determine the conditions under which the treaty claimant may be qualified as a resident for treaty purposes. If a State has not specified a list of residents, there is still the possibility of defining a person as a resident for the purposes of the treaty under the residual category. In other words, even if a person does not specifically have domicile, residence or a place of management in a certain State, there is always the *etc.*[254] in the list to be explored: 'any other criterion of a similar nature'.

It is relevant to highlight, once more, that the recognition of other criteria is also restricted by the rule according to which there cannot be treaty residence in the absence of domestic residence. Irrespective of how similar a criterion may be to those mentioned in Art.4 OECD MC, residence for treaty purposes can never arise in the case of a domestic non-resident. Once again, the example of the Crown Forest case becomes relevant.

After having ascertained that the tax liability of Norsk did not arise because of its place of management, but only because the company was engaged in trade or business in the US, the Federal Court Trial Division considered that fact as a criterion of a similar nature[255]. As a consequence of that, Norsk was defined, noticeably, as a resident *under the laws of the US*. The Supreme Court of Canada amended the ruling by the lower court on the following grounds:

> 'In this respect, the criteria for determining residence in Article IV, paragraph 1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state. In the United States and Canada, such comprehensive taxation is taxation on world-wide income. However, tax liability for the income effectively connected to a business engaged in the U.S., pursuant to s.882 of the Internal Revenue Code, amounts simply to source liability. Consequently, the "engaged in a business in the U.S." criterion is not of a similar nature to the enumerated grounds since it is but a basis for source taxation.'[256]

The conclusion by the Supreme Court of Canada is relevant, inasmuch as it illustrates some of the difficulties in dealing with the expression 'similar nature' in Art.4 OECD MC. The consideration of a place of trade or business as a criterion of a similar nature raises the question as to the elements according to which a domestic criterion, other than those mentioned in Art.4 OECD MC, could give place to residence for treaty purposes.

5.2.3.2. Ascertaining 'similar nature'

The first element to consider when entering into the analysis of the rule is the parameter in relation to which similarity in nature must be measured. While the answer may appear to be obvious, from the ruling of the Supreme Court of Canada it appears that there are several alternatives from which to choose.

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[254] See supra, at p.54.
[255] *Crown Forest*, supra note 13, at pp.820-821.
[256] *Crown Forest*, supra note 13, at p.821.

Firstly, after having analysed the enumerated criteria in Art.4 OECD MC, the court declared that 'similar nature' could only refer to the most comprehensive tax liability imposed by a State[257]. On the other hand, the court also explained that, from a more precise angle[258], both Canada and the United States applied residence taxation on the basis of worldwide income. It therefore concluded that any other criterion had to result in worldwide taxation to be possibly considered similar in nature[259]. Keeping in mind that the engagement in trade or business in the US did not generate worldwide taxation, and neither the most comprehensive form of tax liability imposed by the US, the court rejected the claim.

Vogel, has added a third option, by arguing that the connecting criteria used in Art.4 OECD MC sets standards for a definition of 'similar nature'[260] not in relation to the particular tax system applied by the States but generically, by referring to "any locality-related attachment that attracts residence-type taxation"[261]. As was stated earlier, under this line of reasoning certain factors, such as nationality and place of incorporation would be rejected as criteria of a similar nature, "on account of not being locality-related"[262].

Despite the fact that Vogel seems to have broadened the definition of 'locality-related' attachment later on[263], the question still arises as to the significance of this expression[264] and the circumstances under which 'similar nature' could be ascertained. Bearing in mind that nationality was in principle not considered to be 'locality-related' by Vogel[265], it would be reasonable to conclude that, under this approach, the expression 'similar nature' requires some sort of physical presence in the State in which residence is being claimed. The sole creation of legal ties from the perspective of the person[266] in relation to a certain State would therefore not suffice the condition. In other words, under Vogel's reasoning, by using the expression 'other criterion of a similar nature', Art.4 OECD MC would be restricting the scope of the definition of residence to those treaty claimants who have a personal connection, with a certain degree of substance, with the relevant State[267].

The possibility of sustaining any of these positions is nevertheless complex from the perspective of the Model, and especially from the perspective of the definition of residence in it. In principle, it as has been said that the OECD MC should not be interpreted as setting up standards for domestic residence to give place to treaty residence[268]. An interpretation of the connecting factors leading to the exclusion of certain criteria of tax liability implemented under the laws of the States does not seem to have been the purpose behind the inclusion of the 'other criterion of a similar nature'[269] test. In fact, the reference to similar criteria was introduced[270] in order to embrace

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257 *Crown Forest*, supra note 13, at p.821.
258 *Crown Forest*, supra note 13, at p.810.
259 Same conclusion in Ward, supra note 13, at pp.412-413.
260 Couzin, supra note 20, at p.135.
261 Vogel, supra note 6, at pp.232-233.
262 Vogel, supra note 6, at p.233.
263 '[...] only those criteria are "similar" to the examples given in Art.IV(1) which are of a general nature and either are locality-related or describe a legal tie that may be comparable to citizenship", see Vogel, supra note 113, at p.183.
264 Considering that this theory has found support, see Rust, supra note 216, at p.378; Obrist, et al., supra note 223, at pp.566-567; Hattingh, supra note 235, at p.780.
265 At a certain point nationality was considered to be a criterion of similar nature by the OECD, see TFD/FC/27, at p.1.
266 Message, supra note 238, at p.346.
267 Widrig, supra note 14, at p.286.
268 Sec.4 of Comm. to Art.4 OECD Model Convention (2014).
269 The term appeared for the first time in the 1963 Draft Convention, see C(63)87 Part I, at p.40.
270 This was the first formulation of the connecting factors in the history of the OECD MC: "by reason of domicile, head office or residence, or by reason of any other similar criterion", see FC/WP2(57)2, at p.9.

other factors of tax liability, different than those mentioned in the rule, based on "the various personal connections" a person may have with a particular State[271].

One needs to understand that the definition of residence in the OECD MC refers to a person who is liable to tax by reason of domicile, residence, place of management, or any other criterion which is of a nature similar to the nature of those terms formerly mentioned, and according to the cases that the Model was meant to confront at the time the rule was drafted. Accordingly, there are basically two forms of tax liability covered by the Model. On the one hand, the one imposed 'on account of the taxpayer's personal attachment'[272] to the State concerned and, on the other hand, tax liability on 'income which has been earned in, or received from, the territory of [a] state and property which yields the income mentioned above regardless of any personal attachment to that state (impersonal taxation).'[273]

The connecting factors introduced as examples in Art.4 OECD MC are, in principle, only identifiable with the first category of tax liability. They aim at an attribute of the treaty claimant (domicile, residence, management) and therefore it is in their nature to highlight a relation of a personal character, defined by the laws of each State. The second category of tax liability is defined through the consideration of the income received by the person and not in attention to a personal attribute recognised by law.

This is the very core of the rule or, in other words, the *nature* of the rule, to which any other criteria contained in the laws of the State of residence must be compared. For a connecting factor under domestic law to qualify as being of a 'similar nature', the description of tax liability must be carried on from the perspective of the person, irrespective of the situation of the income[274], or the mechanisms envisaged by the laws of that country to constitute its tax base. Hence, criteria such as length of stay, incorporation, management, habitual abode, location of wealth, citizenship, nationality and so on, could undoubtedly be considered to be of a 'similar nature', if they trigger a tax liability that is not restricted to income earned in, or received from, the territory of a State.

Likewise, the recognition of certain specific forms of residence, inasmuch as they create the conditions for a person to be liable to tax on the basis of personal attributes, plays the same role[275]. The ability to check-a-box, inasmuch as it results in the recognition of a person that, from the moment of the election[276], is attached to that State from a personal perspective and not in relation to the income it receives, may also be characterised as a criterion of a similar nature. At the outset, the existence of criteria of a similar nature rests on the domestic laws of the States[277].

Nevertheless, it is crucial to emphasise that the situation of a non-resident can under no excuse be considered to be a criterion of a similar nature under the relevant treaty. The Federal Court of Canada should have acknowledged that Norsk was not considered to be a resident in the US but,

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[271] C(63)87 Part I, at p.9.

[272] FC/WP2(56)1, at p.1.

[273] FC/WP2(56)1, at p.1.

[274] Lang, supra note 135, at p.598. In the *AIG* case and also in the *Natwest* case, the tax liability of persons who were subject to taxation in India, even as non-residents, was discussed as a potential factor to constitute residence for treaty purposes. See Authority for Advanced Rulings, India, *Natwest* 220 ITR 377; and Authority for Advanced Rulings, India, *AIG* 224 ITR 473.

[275] It has been recognised that a "green card" in the US could be able to be considered as a criterion of similar nature, see Federal Court of Appeal of Canada, *Pamela Alchin v. Her Majesty the Queen*, 2004 FCA 206.

[276] This has been referred to as *tax liability by reason of election*, see Couzin supra note 20, at pp.120-121.

[277] The determination of other criteria of similar nature is fully left to domestic law, for individuals see Dirkis, supra note 83, at p.231; and for companies see Dirkis, supra note 83, at p.333.

on the contrary, was treated as a non-resident. Under those circumstances, even if being engaged in trade or business triggered a certain tax liability in the US, that tax liability was utterly unable to generate a criterion of a *similar nature*. All the OECD MC requires for a criterion to be of a similar nature is to impose a tax liability on the basis of personal attributes, and not exclusively grounded on the income received. The fact that the US and Canada[278] both applied a worldwide system of taxation at that time was irrelevant, at least from the perspective of the 'similar criterion' mentioned in Art.4 OECD MC.

Moreover, following what has been stated in relation to the structure of Art.4 OECD MC and the rules for the determination of residence, when ascertaining similar nature the comparison should only be made on the basis of the rules of the alleged State of residence. In other words, whether Canada applied a certain method for imposing a tax liability on its residents was also irrelevant, and should have been ignored by the court for the purposes of the comparison.

5.2.4. The connecting criteria in States applying territorial taxation

It is worth mentioning that the concerns in relation to States applying a territorial system of taxation did not originate at the same time residence was discussed, but arose much later. They came about in 1992, when a new interpretation of the second sentence of Art.4(1) OECD MC was introduced to the Commentaries[279], so as to exclude conduit companies from treaty benefits[280]. Considering that this provision excluded from the definition of residence persons who were "liable to tax in that State in respect only of income from sources in that State or capital situated therein"[281], the need arose to clarify that residents of territorial States were not automatically excluded from the scope of the Model[282]. Regardless of the possibility of sustaining such an interpretation from the perspective of the second sentence, which will be explored in detail in subsequent parts of this work[283], the configuration of Art.4 OECD MC seems to pose some technical difficulties in achieving such an intention.

According to Lang, the tax liability of a person who is a resident of a State applying a territorial system of taxation arises as a consequence of the place from where the income originates, and not in relation to personal factors. In other words, those States decide to extend their tax jurisdiction "regardless of domicile, residence, place of management, or any other criterion of a similar nature"[284], but only on account of the income received.

By way of illustration, a company would be liable to tax in France as a result of its activities being performed therein and not, at least in principle, because of its residence or place of management[285]. While French corporations normally have access to treaty benefits derived from the application of agreements entered into by France, even if that State is known for applying a territorial system of taxation in relation to corporations, the question arises as to the rules under

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278 The situation in Canada, in fact, should not have been considered, inasmuch as the test of residence must be appreciated exclusively from the perspective of the alleged State of residence, which in this case was the US, see supra, at p.37.
279 The addition of this rule is analysed in detail in Chapter 7.
280 For an explanation to the reasons given see OECD, *Double Taxation Conventions and the Use of Conduit Companies*, (Paris: loose-leaf, 1986); and OECD, *Double Taxation Conventions and the Use of Base Companies*, (Paris: loose-leaf, 1986).
281 Art.4(1) second sentence of the OECD Model Convention (2014).
282 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).
283 This aspect of the definition of residence in analysed in Chapter 10.
284 Lang, supra note 135, at p.597.
285 de Boynes, supra note 172, at pp.454-455.

which such companies obtain treaty entitlement. Some have argued that the rules under which the tax jurisdiction of France is extended to French corporations would be understood as a criterion of a similar nature[286], inasmuch as the company is generally subject to the taxation laws of France[287].

As has been explained before, however, the extent of the connecting factors in Art.4 OECD MC and even of any criteria of a 'similar nature' is in principle restricted to the verification of tax liability from the perspective of the person, and not in relation to the income[288]. Whilst tax liability on the basis of the income arising from sources in a State seems to be the rule at the core of a territorial system of taxation, the question arises as to the possibility of not excluding these persons from the application of the Model. Arguably, any attempt to include persons who are residents of a State applying a territorial system, given the configuration of Art.4 OECD MC, requires an effort of creativity. However, the consideration of the elements *by reason of* which tax liability arises provides some reasons to sustain that these persons should not be excluded from the application of the Model.

Firstly, if a broad conceptualisation of the connecting factors is adopted, and the rule of Art.4 OECD MC is read as a generic reference to domestic law[289] (such as 'resident is a person that is liable to tax by reason of domestic law', or 'a resident of State A is any person who is a resident of State A under State A's laws'), in principle there would not be any reason to exclude these persons from treaty residence. On the contrary, only if one follows a restrictive interpretation of the rule, difficulties would arise in including these persons. All this depends on the conceptualisation of the connecting factors described in the OECD MC.

Secondly, even if tax liability under the Model must be based on the existence of a personal connection, it may be argued that the fact that a State applies the territorial system does not imply that tax liability in that State is ascertained in the absence of 'any personal attachment'[290]. On the contrary, those persons would in fact be considered to have a strong allegiance to that State, an economic nexus capable of justifying the existence of tax liability in their respect[291]. The only consequence derived from the application of the principle of territoriality in relation to them would be the delimitation of their tax base to income arising from sources in that State. Under such an approach, tax liability could not be described as absolutely impersonal.

Arguably, even if the intention not to exclude States applying a territorial system is a well-intentioned one, and even if the effects of the second sentence of Art.4 OECD MC (which provides additional elements for the discussion) are ignored, the definition of residence seems to pose important obstacles in materialising the intention not to exclude these States from the application of the Model.

5.3. Evaluation: Tax liability by reason of connecting criteria

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286 Gest, Guy, Texier, Gilbert, *Droit Fiscal International*, 2ed., (Paris: P.U.F., 1990), at p.188.
287 Referred to by Couzin as '"plenary" or "comprehensive" taxation', see Couzin, supra note 20, at p.134.
288 FC/WP2(56)1, at p.1.
289 To Couzin, in principle, this would not be correct, see Couzin, supra note 20, at pp.130-131.
290 FC/WP2(56)1, at p.1.
291 Regardless of the fact that courts do not normally refer to the concept of residence in tax treaties, this has been the formula applied by France in relation to corporations which are subject to a territorial system of taxation, see de Boynes, supra note 172, at pp.446-450 and at pp.454-455. This position would be supported by the consideration of 'source' between the criteria of entitlement in the history of the Model: "Such Conventions apportion between the two contracting States in accordance with certain criteria (known as criteria of attachment, such as domicile, location, place of employment, *source*), the right to tax […]", see FC/WP2(57)2, at p.5.

Even if one considers a particular interpretation of the connecting criteria giving place to domestic tax liability on the basis of a 'locality-related' requisite, to sustain that such an interpretation carries with it the need of a strong nexus is highly unconvincing[292]. Firstly, the history of the Model demonstrates that the connecting factors were supposed to be conceived as broadly as possible. Secondly, and most fundamentally, because it is hard to sustain that a criterion such as incorporation may not be of 'similar nature' in one State if, at the same time, it is acknowledged that if that country had included incorporation in the catalogue of residents, the benefits of the convention should not be denied.

Despite these difficulties, it is fairly clear that the conceptualisation of the criteria of attachment in Art.4 OECD MC, and particularly the description of criteria of *similar nature*, reinforces the conclusion that the connection of authority defined by the term 'liable to tax' focuses almost absolutely on subjective factors. The nature of the tests to which any other factor may be compared to verify its similarity is, in essence, subjective. In other words, what matters for a criterion to give place to tax liability and thus to residence under the Model, is the verification of an attachment between a person and a State that is not exclusively based on the income that the person receives. On the contrary, such a connection must arise as an effect of a personal submission to the tax authority of the State in which treaty benefits are claimed.

The list of examples in Art.4 OECD MC (domicile, residence and place of management) does not restrict in any way the ability of other factors to generate residence in tax treaties. All the Model requires to be applied is tax liability on the basis of a personal attachment and not solely in attention to the income received[293]. In this sense, at the domestic level the States impose generic conditions, such as nationality, citizenship, residence, a period of stay, management, abode, incorporation, amongst others, and they even consider cases of deemed residence. Accordingly, when attributing its ordinary meaning of the term 'liable to tax', one should not readily assume that there is something in the term which implies the need for a locality-related attachment, economic substance, or any other factor behind a tax treaty claim. If these criteria were used at the domestic level, they must not be left outside the scope of the Model because it was not the intention of the OECD to restrict the list of factors which were capable of establishing treaty residence. Finally, it is worth mentioning that residents of States applying the territorial principle of taxation should not be excluded from the scope of the Model, and this has consequences for a conceptualisation of the connecting criteria as well. Bearing this in mind, one must understand that, although their tax base is restricted, they do possess a link with the State in which they *reside* that is based on personal factors. Otherwise, the inclusion of these persons within the scope of the Model becomes quite hard to sustain.

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292 Even under the form of an implicit anti-abuse principle, as argued by Bammens, Niels, and de Broe, Luc, 'Treaty Shopping and Avoidance of Abuse', in Lang, M., et al., (eds.), *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), at p.72.

293 FC/WP2(57)3, at p.5.

6. Chapter 6
'Liable to tax' as a relation of tax authority

6.1. Introduction: The tax authority of a State over the treaty claimant

So far it has been stated that the ordinary meaning of the term 'liable to tax' requires the presence of a separate taxable unit that is liable to tax under the laws of the State of residence. Given the manner in which the first sentence of Art.4(1) OECD MC has been drafted, it is more or less evident that another relevant standard imposed by the rule refers to the connection of authority between the treaty claimant and the State in which treaty benefits are claimed. The OECD has described some of the fundamental features of this connection of authority in the Commentaries, and it seems that the purpose behind this is to describe the cases in which tax treaties need to be applied. Many of these elements, however, generate inconsistencies in relation to the meaning of the term 'liable to tax', creating a series of difficulties when interpreting and applying tax treaties.

By way of illustration, it is not clear whether the term 'liable to tax' is restricted to cases of worldwide taxation. Yet if it were accepted that this is so, then the Commentaries would create a conflict when stating that residents of States applying the territorial principle of taxation should not be excluded from its scope of application[294]. Moreover, bearing in mind that the point of departure for any treaty claim lies in the consideration of the person as a resident domestically, such a person may be considered to be 'liable to tax' in more than one State. The OECD MC deals with the issue of dual residence in the tie-breaker. However, the situation becomes less clear if a person were considered to be 'liable to tax' in more than one State during the same taxable period, but not exactly at the same time. This is a situation to which the Commentaries to the Model also refer. Furthermore, despite the fact that Art.4(1) OECD MC imposes as a condition for the application of the Model not a general liability, but a liability *to tax*, it is not clear whether the rule refers to any taxes in particular.

It is fairly evident that the OECD has provided certain guidelines to describe the term 'liable to tax' and therefore to decide, on the basis of these elements, whether a certain treaty claim may be accepted within the scope of the Model or not. What remains unclear, however, is the manner in which these elements contribute to the attribution of its ordinary meaning to the term 'liable to tax'. The following paragraphs attempt to confront all these issues.

It is nonetheless relevant to reiterate and emphasise that, as was stated earlier, according to the definition of residence the connection of authority and the requirements for it depend on the rules of the State of residence only[295]. Thus, when analysing the potential tax liability of a certain person, even in a bilateral context, the rules of the State of source must be completely overlooked.

6.2. Physiognomies of tax liability from the perspective of the Model

6.2.1. Introduction

The ability to obtain treaty benefits rests on the recognition of a specific status to the treaty claimant. That status, however, is not possessed in the abstract, but it only arises as an effect of the "taxpayers' personal attachment to the State concerned"[296]. The right to claim treaty benefits results from the allegiance to a State, the precise form of which is, supposedly, in no way limited.

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[294] Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).
[295] Lang, supra note 135, at pp.597-598.
[296] Sec.3 of Comm. to Art.4 OECD Model Convention (2014); see also FC/WP2(56)1, at p.1.

In fact, according to the Commentaries, "the definition aims at covering the various forms of personal attachment to a State, [and] it also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State"[297]. There are thus certain peculiarities of the allegiance to which the term 'liable to tax' refers, in such broad terms.

6.2.2. The general character of 'liable to tax' and worldwide taxation

Considering that the extension of a State's tax authority over a person is normally construed on a formal basis, generally related to the circumstances of the person, tax liability has a general character. This implies that, in essence, the term 'liable to tax' refers to an authority that is not necessarily limited to certain spheres of the person or to specific acts carried out by it. On the contrary, the extent of a State's tax jurisdiction is in principle unrestricted. This means that it applies to the person and thus to all his activities, to all the different acts it enters into, and to the many items of income it receives. The general character of tax liability only finds a limit where the authority of another State is applied over the same person, and in such a case the conflict is solved, according to the Model, by giving preference to one claim over the other.

The general character of tax liability has traditionally been equated to the need of being subject to worldwide taxation[298]. The idea probably results from the comparison with States applying a territorial system. Seemingly, the fact that the authority of a State is not limited to certain items of income arising from sources located in a State sets the grounds for the conclusion. Yet the aim of the Model is diverse, and the ways in which a State exercises its tax authority ought not to be considered to be subject to any kind of restriction[299]. On the contrary, as has been mentioned before[300], the existence of tax liability in a State does not depend on the tax system applied by that State. All the ordinary meaning of the term 'liable to tax' requires is the extension of a State's tax authority on the basis of a certain allegiance between the State and the person on which that authority is exercised.

This should be the case even in States in which the source of the income plays a preponderant role, as in the case of territorials. One must always keep in mind that the Model is expressly meant not to exclude these States[301]. Thus, when attributing its ordinary meaning to the term 'liable to tax', one should keep in mind that, as has been suggested in France[302], the system of territoriality is only relevant insofar as it restricts the relevant tax base, but it cannot imply that the person as such does not have an allegiance to the relevant State. On the contrary, companies are liable to tax in France *by reason of* their allegiance to France, under its laws, and not simply because of their income arising therein.

6.2.3. 'Liable to tax' is a permanent attribute

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[297] Sec.8 of Comm. to Art.4 OECD Model Convention (2014).

[298] Salom, Jessica, 'The Attribution of Income in Swiss and International Law', in 66 *Bulletin for International Taxation* 5 (2011), at p.400; Hattingh, with reference to the history of Art.1 OECD MC, see supra note 51, at p.217; Hattingh, with reference to the role and function of Art.1 OECD MC, see supra note 51, at p.550; Bellens, supra note 238, at p.292; Message, supra note 238, at p.347; Rust, supra note 216, at p.377; Nuñez, supra note 240, at p.522; Obrist, supra note 223, at p.563;

[299] "The taxation of world income does not offend the territorial principle", Couzin, supra note 20, at p.7; Vogel, supra note 6, n.32, at p.234. In fact, to Vogel under the OECD MC "a person may be a resident of a State which taxes nothing but domestic source income", see supra note 6, n.24, at p.229; Daurer, supra note 238, at p.259; in relation to Canada see Brooks, supra note 127, at p.433.

[300] In the context of the Crown Forest case, extensively commented in Chapter 5.

[301] Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).

[302] See supra, at pp.60ff, the analysis of similarity in nature in relation to States applying the territorial principle.

Considering the manner in which the domestic laws of the different States set up their own definitions of residence, the ordinary meaning of 'liable to tax' suggests that this is a permanent attribute. This means that the allegiance of a person to a State which gives rise to the attribute is, in principle, not limited in time. It remains day after day while the conditions that gave place to it according to the laws of a State continue, even if the person does not enter into any arrangements that are relevant for tax purposes.

This, however, does not mean that tax liability is perpetual. The extension of a State's tax authority over a certain person is a legal phenomenon which would end if the person ceases to comply with the conditions imposed by the laws of that State to be considered as a resident. This would occur even if the person leaves the State, provided that the laws of such State create a fiction in order to discourage the speculation in relation to the status of resident (for instance trailing taxes). During the time in which the authority of a State is extended over a person, and even during the fictional period, the person will still be liable to tax in that State on all its acts.

6.2.4. Tax liability is abstract

Further, tax liability represents an abstract relation, inasmuch as it exists regardless of the material exercise of the authority it entails over a certain person. At all times, while the requirements imposed by domestic law are met, the taxpayer will remain 'liable to tax' in a State, even if the authority of that State is only latent and not positively put to work. Despite the question of whether effective taxation is required for tax liability to arise, the intention of the OECD to cover all the different possible manners in which this attachment may exist implies that tax liability represents, in plain words, a State's authority to subjugate a person to its rules of taxation. This means that if the State does not exercise that power, it does not lose the prerogative to do so. In fact, this power may be unexercised even for years. Although the person may never enter into any acts with tax consequences, that would not affect its status as a tax resident for the purposes of domestic law, and therefore of any relevant tax treaty.

6.2.5. 'Liable to tax' does not refer to any tax in particular

As an effect of the particularities of the term 'liable to tax', and despite the obvious reference implied in the term itself, the expression does not refer to any taxes in particular. Tax liability is an attribute that, in order to generate residence, must be observed from the perspective of domestic law. At that level the States apply a variety of different taxes. The term 'liable to tax', however, does not refer to any of them[303]. Two cases that would illustrate this dimension of the meaning of 'liable to tax' in the context of the OECD MC are worthy of consideration.

Firstly, the tax authorities of India denied treaty entitlement to a person resident in Germany and subject to trade tax therein, under the argument that the person was not 'liable to tax'[304] in that State. The court amended this decision by ruling in favour of the taxpayer. Although the ruling was based on the presence of trade tax in Article 2 of the India - Germany tax treaty, even if the treaty did not contain such mention the solution could not have been any other. Tax liability is an attribute of persons, which is moreover abstract. Thus, in order to determine whether the person was in fact a resident in Germany or not for the purposes of the treaty, the fact that it was subject

[303] Tax liability in relation to taxes mentioned in Art.2 OECD MC is apparently needed in Belgium, see Bammens, Niels, 'Belgium' (Country Reports), in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at pp.393-394.

[304] Income Tax Appellate Tribunal (ITAT) Mumbai, 30 September 2010, *ADIT v. Chiron Behring GMBH & Co KG*, (2010) 9 TMI 627 (ITAT Mumbai).

to none of the taxes included in Art.2 of the relevant treaty was immaterial. Only the fact that the tax jurisdiction of Germany could be applied to that person should have sufficed for an argument. Regardless of the objections that the case may present in terms of policy, given the structure of Art.4 OECD MC, the claimant should not have been denied those benefits[305].

This issue was also discussed in the *Mohsinally Alimohammed Rafik* case, also in India[306]. In the context of the treaty between India and the United Arab Emirates (UAE), an individual, resident in the UAE, claimed the benefits of the convention for income arising in India. The benefits of the treaty were recognised by the Indian court even if it was known that the UAE did not impose any individual income tax. The argument of the court referred to the fact that, between other reasons, the rules according to which a person is qualified as 'liable to tax' in a certain State depend on personal attributes, and not on a State's prerogative to exercise its tax authority. If the laws of a State grant residence to a person for tax purposes, irrespective of the particular taxes to which the person is in fact subject, the ordinary meaning of the term 'liable to tax' prevents the denial of treaty benefits.

These cases demonstrate that whether the rules of the State of residence impose any tax liability on taxes considered in the OECD MC is immaterial for the purposes of attributing its meaning to the term 'liable to tax'. The term does not refer to any tax in particular, but only to taxes *on income and capital*, as the title of the Model indicates. Thus, according to the ordinary meaning of 'liable to tax', a person who is subject to the tax authority of a State in respect to taxes not included in the Model may perfectly well be considered to be a resident for tax treaty purposes.

6.2.6. Moment of tax liability

The definition of residence is meant to cover the different forms of personal attachment between a person and a State. This, however, does not imply that the OECD has not sought to impose certain limits to this concept.

The exact time at which a certain act is carried on or income is received does not seem to be relevant for the purposes of tax liability as defined from a domestic perspective. As was stated earlier, tax liability is a permanent attribute of persons. All that matters is that the person, when claiming the benefits of a tax treaty, was or had been liable to tax in that State during a certain period in a way that generates a personal tax liability, and not necessarily one that arises in connection with particular sources of income.

This has important practical consequences, insofar as the States determine tax liability under domestic rules on the basis of different temporal criteria. In the Smallwood case[307], a person resided during part of the year in one State, and then moved its residence to a different State for the rest of the year. Under their respective laws, both States considered the person to be a

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305 Wheeler, supra note 11, at p.9.

306 Authority for Advance Rulings New Delhi, 23 December 1994, *Mohsinally Alimohammed Rafik* (1995) 213 ITR 317 (AAR). This case has been confirmed by several other rulings, see Income Tax Appellate Tribunal (ITAT) Mumbai, 04 May 2011, *Mahavirchand Mehta v. ITO*, (2011) 5 TMI 35 (ITAT Mumbai); see Income Tax Appellate Tribunal (ITAT) New Delhi, 26 August 2011, *DDIT v. Mustaq Ahmad Vakil*, (2011) 8 TMI 446 (ITAT Delhi); Income Tax Appellate Tribunal (ITAT) Mumbai, 29 October 2009, *Meera Bhatia v. Income Tax Officer*, (2010) 38 SOT 95 (Mum)

307 United Kingdom, Court of Appeal (Civil Division), 08 July 2010, *HMRC v. Smallwood and Anor*, [2010] EWCA Civ 778. For a more detailed analysis of the Smallwood case see Schwarz, Jonathan, 'Avoidance and Tax Treaties: Current UK Experience', in 65 *Bulletin for International Taxation* 8 (2011), at pp.453-459; Cleave, Brian, 'The Smallwood Case: Dual Residence of Trustees', in 65 *Bulletin for International Taxation* 8 (2011), at pp.460-468; Lemos, supra note 217, at p.619; and Wheeler, supra note 11, at pp.125-131.

resident for the entire period, because the person was liable to tax in each country during part of the year. Accordingly, having received income during the period of residence in the first State, both States, however, claimed the right to tax that income as the State of residence[308].

The particular effect of having configured a system where the person is the cornerstone for the application of tax treaties results in these kinds of conflicts. Despite the fact that there was no overlap at the time the income was actually received, both States raised a claim on the person in relation to that income, because the person was, at different times, considered to have an allegiance with both States. Although the taxpayer argued that no conflict would have arisen if the court used a 'snapshot approach'[309], fixing its attention on the tax liability generated at the precise moment in which the income was received, the court disregarded the argument and the person was in fact treated as a dual resident[310].

Regardless of the opinion one might have in relation to the outcome of the case or the reasoning of the court, a fully domestic conceptualisation of residence as an attribute of persons is capable of generating these scenarios[311]. Even a tax liability limited in time may generate residence for the purposes of the entire relevant period, if treaty residence is defined as equivalent to domestic residence. Under this reasoning, even if a person resides in a State, and then changes its residence to a different State, a dual residence conflict may arise in the absence of any temporal overlap[312].

The OECD has nonetheless recorded its non-conformity with the outcome of the Smallwood case in the Commentaries, and this is a crucial standard the Model seeks to impose when defining residence from a tax treaty perspective. According to the Commentaries, one would have to prefer the *snapshot approach*:

> "The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December."[313]

The fact cannot be missed that this way of defining residence at the treaty level is in open contradiction with the intention, also mentioned in the Commentaries, not to impose standards on domestic residents to access the Model. This essential contradiction prevents one from knowing, with a reasonable degree of clarity, whether the outcome of the Smallwood case is adjusted to the terms of the Model or not.

On the one hand, if one relies exclusively on domestic factors (thereby not imposing any standards from a treaty perspective), the precise moment at which the income is received should be disregarded, insofar as the person would be liable to tax in that State during the relevant taxable period. Following this path will take one to the conclusion that simultaneous residence in

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308 In the Special Commissioners' opinion in the Smallwood case: "we do not consider that "by reason of…residence" means solely past or current residing. If residing in a subsequent period causes residence for the whole year, then liability is by reason of residence", see *Smallwood*, supra note 18, at para.102.
309 *Smallwood*, supra note 307, at para.65.
310 Lemos, supra note 217, at pp.620-621.
311 Wheeler, supra note 11, at pp.125-131.
312 *Smallwood*, supra note 307, at para.43 and 46.
313 Sec.10 of Comm. to Art.4 OECD Model Convention (2014).

two States would not be needed for the dual residence conflict to arise[314]. Moreover, one would have to conclude that the interpretation of the court in the Smallwood case would not oppose the terms of the Model. On the contrary, if one decides to apply the temporal standard imposed by the Commentaries to the conceptualisation of residence at the treaty level, then a snapshot approach would have to be applied. This would nevertheless imply that residence at the treaty level is not exactly equivalent to residence at the domestic level. Logically, this would also imply that the judges in the Smallwood case were wrong.

The ordinary meaning of the term 'liable to tax', based on domestic law, increases the potential for dual residence conflicts. Yet, one cannot forget that the OECD does not seek to create ideal rules of taxation, but to elaborate a Model that can be of widespread adoption, based on the customary use of tax rules.

6.3. Tax liability of the State and political subdivisions in Art.4 OECD MC

The idea of defining tax liability as a generic submission to a State tax authority carried the need to modify the text of the Model at a certain point in time. According to the Commentaries, there was an historic tendency to recognise the benefits of a tax treaty to the contracting States, as well as to any political subdivision and local authority[315] thereof. This occurred despite the fact that those entities could hardly be submitted to its own tax jurisdiction. Therefore, the OECD modified the text of Art.4 OECD MC in order to set up an exception, according to which the term 'resident of a contracting State' "also includes that State and any political subdivision or local authority thereof"[316], in order to allow these entities to claim treaty benefits. If the addition had not been made, regardless of the consideration of these entities as persons[317], the ordinary meaning of the term 'liable to tax' would not have been capable of securing those benefits[318].

6.4. Evaluation: 'Liable to tax' and the submission to a State's tax authority

Bearing in mind the manner in which both the Model and the Commentaries describe the meaning of the term 'resident', it is more or less clear that the relation of authority portrayed in it seeks to represent the different manners in which tax authority is extended upon domestic residents. Tax liability, under Art.4 OECD MC, must arise by reason of a personal factor, capable of submitting the person to the authority of a State in a manner that is not limited to specific flows of income. One needs to bear this in mind when attempting to answer the question of what the peculiarities of the connection of authority represented by the term 'liable to tax' are.

On the one hand, it may be observed that tax liability has a general character, but that the need not to exclude residents applying the territorial principle from the scope of the Model implies that such character is not limited to worldwide taxation. Secondly, it may also be said that tax liability is a permanent attribute and that, as such, is not limited in time. Thirdly, tax liability is abstract, because it exists regardless of the material exercise of that authority over the person. In other words, the authority of a State cannot be considered to be relinquished if it is not exercised. Moreover, tax liability does not refer to any taxes in particular, but only to a submission to a

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314 Although Sasseville does not agree, see Sasseville, Jacques, 'Temporal Aspects of Tax Treaties', in Baker, Ph., et al., (eds.), *Tax Polymath*, (Amsterdam: IBFD, 2010), at p.51.
315 Sec.8.4 of Comm. to Art.4 OECD Model Convention (2014).
316 Art.4 OECD Model Convention (2014).
317 Vogel, supra note 6, n.15, at p.172.
318 Couzin, supra note 20, at pp.11-112.

State's tax authority that is, as has been stated many times before, only based on personal attributes.

Perhaps the only source of problems when trying to define treaty residence so as to include all potential subjective attachments between a person and a State derive from the temporal conceptualisation of residence in the Model. According to the Commentaries, if a person shifts its residence from one State to another during the same taxable year one should pay attention to the specific periods during which that person was liable to tax in each State (the so-called *snapshot approach* in the Smallwood case). While this is a fundamental standard the Model seeks to impose to domestic residents in order to be considered as treaty residents, one cannot ignore the fact that this interpretation of the rule contradicts the intention, also mentioned in the Commentaries, to include all possible variations of domestic residence. This is why one cannot categorically sustain that the outcome of the Smallwood case does not follow the guidelines contained in the Commentaries. The temporal aspect of the definition of residence poses a crucial condition to access the OECD MC.

7. Chapter 7
Comprehensive, unlimited and full tax liability

7.1. Introduction

The terms 'comprehensive', 'full' and 'unlimited' tax liability are often presented as a consequence of the addition of a second sentence to Art.4(1) OECD MC, in 1976. These terms, the significance of which is highly unclear, are allegedly meant to set out a meaning of the term 'liable to tax' that is different than that in the first sentence of Art.4(1) OECD MC. There are many reasons to sustain, however, that this proposition is far from being certain.

The addition of a second sentence to Art.4(1) OECD MC was driven by the need to solve a very specific issue in the case of diplomats. In practical terms, these persons were favoured by the existence of international instruments containing extensive tax benefits. In order not to interfere with the application of such instruments, these diplomats had to be left outside the scope of the OECD MC and, consequently, of tax treaties. Many years later, when the OECD had to confront the issue of treaty abuse, a decision was made to deal with this situation by promoting a certain interpretation of this second sentence in the Commentaries. Needless to say, this new interpretation broadened the scope of application of the rule far beyond the limits its original drafters had in mind. After being modified in 1992 and 2008, the Commentaries today state that the rule has a *spirit* which is capable of excluding from the definition of residence certain treaty claimants, such as conduit companies and residents of States having lost a tie-breaker under Art.4(2) and 4(3) OECD MC. Whether the second sentence of Art.4 OECD MC is in fact capable of supporting such an interpretation (considering the context in which it was added to the Model), is highly unclear. Moreover, the aptitude of the rule to deal with scenarios of treaty abuse is also a major concern.

Furthermore, the rule has introduced several other obstacles for a coherent interpretation of the Model. By way of illustration, after having changed the Commentaries in 1992 and 2008, the OECD had to clarify that the rule is not supposed to leave residents of territorial States outside the scope of the definition of residence. The answer to the question of whether this is possible is, nonetheless, rather doubtful, because the OECD has referred to conduit companies merely as entities whose entire foreign income is tax-exempt. The possibility not to exclude residents from a State applying the territorial principle of taxation under these rules is therefore quite hard to sustain. Arguably, the expressions used by the OECD to describe the term 'liable to tax' are obscure and misleading, and this threatens a fair and reasonable interpretation of tax treaties.

7.2. Tax liability and residence under Art.4 OECD MC before 1963

7.2.1. Residence was meant to replace 'full tax liability' in Art.4 OECD MC

Historically, the excessive narrowness of the term 'fiscal domicile' gave place to the discussion on how to set up a broader rule of treaty entitlement. To the drafters of the OECD MC, its widespread adoption depended fundamentally on the capacity of the text to blend into any tax system, and this in turn was subject to the use of common terminology. The Model needed to be compatible with the different domestic laws of the States that were expected to use it[319], and the term 'domicile' was not so common[320].

In that context, the expression 'full tax liability' was proposed in order to explain the personal attachment that gave place to fiscal domicile[321], without leaving aside the many other ways in which the States defined the extent of their tax authority[322]. This new expression, although broader in scope, was nevertheless unfamiliar to those States. In fact, it was the opinion of the Fiscal Committee that '[i]t was essential to try not to rely on the concept of "full liability" but to refer instead to national concepts"[323]. After discussing several draft provisions under the formula 'fully liable to tax'[324], the reluctance of the States to adopt the term was finally accepted by the OEEC:

> 'The discussions in the Fiscal Committee have given the Working Party the impression that there has been some hesitation in abandoning the usual terms and replacing them by the terms: a full or a limited liability to taxation. […] The terms proposed do not appear to be current in all the Member States. At any rate the word "full" would presumably have to be dropped. This would mean that in the subsequent articles of the Convention the brief expression "the State in which he is fully liable to taxation" could not be used, but it would be necessary to say: "the State in which he is liable to taxation by reason of domicile, residence, etc.". For terminological reasons it would be desirable if "a shorthand expression" could be used in all cases where the State of "domicile" is mentioned. In view of this position, the Working Party thought it should find a brief term as stated and endeavour to make its meaning clear by means of a definition. Consequently the Working Party has fixed upon the term "resident"'[325].

At the outset, the term 'resident' was adopted. Notwithstanding the apprehensions that the use of the term 'fully liable to tax' caused, the expression 'liable to tax' was placed at the heart of the concept[326]. Further, the adjective 'full' was kept in the Commentaries, in addition to the term 'more comprehensive', to describe what liability to tax was[327]. Regardless of the fact that the term 'resident' was meant to replace the expression 'full tax liability', it is clear that the purpose of the change was not fulfilled. By defining residence through the term 'liable to tax', and by further describing it as 'full' and 'comprehensive' in the Commentaries, it is these expressions which govern the application of tax treaties, and not the term 'resident' in itself.

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319 "The Committee thought it preferable to elaborate first a definition that could be accepted by all Member countries without thereby entailing any modifications in the definitions in their respective civil or fiscal legislations which would be difficult to standardise", see FC/M(56)2(Prov.), at p.4.

320 "There appears to be slight reason only to continue speaking of a concept of domicile in this sphere. Beyond the fact that attachment through domicile will continue to be a very important factor for the determination of which of the two states is to be given preference, it may presumably be said that when making arrangements for the avoidance of double taxation the two states are entitled to choose any criterion they find expedient under the existing circumstances", see FC/WP2(56)1, at p.2.

321 FC/WP2(56)1, at p.1.

322 "Article I: This agreement shall apply in every case where a person is fully liable to taxation in one of the Member countries. […]; Article II: Where a person is fully liable to taxation in more than one Member country, the right to tax shall belong: […]; Article III: Where any person has a limited liability to taxation in a Member country in respect of income originating in that country, or in respect of capital therein, and is furthermore fully liable to taxation in another Member country, the right to tax shall belong to the latter country unless it is otherwise provided in the following Articles", FC/WP2(57)1, at pp.2-3.

323 FC/M(57)2, at pp.5-6.

324 FC/WP2(57)2, at pp.1-12.

325 FC/WP2(57)3, at p.6.

326 And so it appears in the first draft of the rule: 'For the purposes of this Convention, the expression "resident" of a State means any person who, under the national law of that State, is liable to taxation therein by reason of his domicile, residence, head office, nationality or some other similar personal criterion", see TFD/FC/27, at p.1, and the version approved by the Fiscal Committee in FC/M(58)I, at p.9.

327 'Generally the national legislations of the various States impose a more comprehensive liability to tax – "full tax liability" – on account of the taxpayer's personal attachment to the State concerned', see FC/WP2(58)1, at p.3.

7.2.2. 'Full' and 'limited' tax liability before the issue of diplomats

Today, literature struggles with the significance of the terms 'full', 'comprehensive' and 'unlimited', trying to ascertain the manner in which these terms shed light on the meaning of the expression 'liable to tax'. Some authors have in fact suggested that there is nothing useful in the expressions[328], an idea that, from the confusing case law on the matter, seems highly plausible. Arguably, this was not so much of an issue when the first versions of what would become the OECD MC were discussed.

At that time, there was a clear distinction between 'full' and 'limited' tax liability for treaty purposes. The illustration of the two classical double taxation situations to which the Model was supposed to be applied sheds plenty of light on this distinction:

> "(1) where, under their internal legislation, two states both impose full tax liability *on account of the taxpayer's personal attachment* to the states concerned (the requirement of subjective tax liability being fulfilled in both states), and
>
> (2) where one state taxes income which has been earned in, or received from, the territory of the other state and property which yields the income mentioned above *regardless of any personal attachment* to that state (impersonal taxation), while in the other state the person concerned is burdened with full tax liability on account of his personal attachment to the latter state."[329]

While the Model was meant to include within its scope only those persons who would demonstrate a certain level of personal attachment to a certain State, it was supposed to leave aside others who did not have it[330]. Before 1977, the distinction between 'full', 'comprehensive' and 'unlimited' as equivalent terms on one hand, and 'limited' on the other, was relatively simple. If the person was liable to tax on the basis of personal attributes, that tax liability was labelled as 'full'. If, on the contrary, the person was liable to tax not on the basis of such features but only as a consequence of particular flows of income arising in a certain State, his tax liability was catalogued as 'limited' or 'impersonal'. Under such a binary division of taxpayers, the tax liability of a partially exempt resident or a conduit structure, without any further clarification, would have clearly been considered as 'full'. Insofar as a relation existed between a person and a State, somewhat similar to what the States customarily defined in their laws as residence, full tax liability for the purposes of the definition of residence in the Model was certainly said to exist.

7.2.3. The issue of diplomats and the need for a clarification

In the context of a clear distinction between residents and non-residents for treaty purposes, an issue aroused the OECD's attention: the situation of diplomats[331]. There were a series of scenarios in which the laws of the sending and the receiving States[332] could cause difficulties when applying

328 Couzin, supra note 20, at pp.153.

329 Emphasis added. FC/WP2(56)1, at p.1. Moreover, when the reasons behind the rule were explained, it was stated: 'The considerations mentioned in paragraph 5 led the Working Party to consider whether it would not be preferable to replace the term "domicile" by the term "full liability to taxation". In contrast to this the term "limited liability to taxation" could then be used where a State taxes income which has been earned in it, or received from it, this *regardless of any personal attachment to that State* (source of income), emphasis added, see FC/WP2(57)3, at p.5.

330 "Accordingly, only such cases will be excepted from the scope of the Agreement as involve double taxation as a result of a taxpayer's income being subject to limited liability to tax in two countries", see FC/WP2(57)1, at p.4.

331 The first mention to this subject is found in 1958, see FC/M(58)3, at p.10.

332 The expression 'sending State' was used during the discussion of the Model to identify the State represented by the diplomat, and the term 'receiving State' to single out the State in which the diplomat fulfilled his function. For the sake of simplicity, the same terminology will be used in this study.

the Model. The analysis of this issue by the OECD resulted in a brief addition to the Commentaries to Art.4 OECD MC in 1963, and a second sentence to the first paragraph of the rule itself in 1976[333]. Many of the difficulties in interpreting tax treaties today derive from the inclusion of this rule, especially since the OECD decided to use it for other purposes by modifying the Commentaries in 1992[334] and 2008[335]. Bearing in mind the magnitude of the changes introduced by the OECD[336], the history of the second sentence of Art.4(1) OECD MC seems to be crucial in order to illustrate its original scope. In a way, this would clarify whether the rule is in fact able to support the restrictions on the rule of residence that the OECD has sought to impose.

7.3. History and scope of Art.4(1) second sentence OECD MC

7.3.1. The issue of diplomats and the history of the new rule

7.3.1.1. First part: Before the 1963 Draft Convention

The origin of the second sentence of Art.4(1) OECD MC can be traced back to 1958. At that time, the study of a "reservation of international law for diplomatic and consular representatives"[337] was under scrutiny. Working Party 14[338], set up for the study of this matter, proposed the addition of the following rule to the Model:

> "The provisions of the present Convention shall not affect *the right to more extensive exemptions* which are granted to diplomatic or consular officials by virtue of the general rules of international law or by special agreements. Insofar as, under this system of more extensive exemption, income and fortune are not subject to tax in the receiving State, the right to taxation shall be reserved to the State which such officials represent."[339]

The scope of the rule proposed can be explained by using an example: On the one hand, there is the State sending the diplomat (State S), and on the other hand the State receiving him (State R). Both States treat the diplomat as a resident under their domestic law, and they have entered into a treaty based on the OECD MC. The diplomat is therefore entitled to the benefits of that treaty and, at the same time, to certain privileges under other rules of international law (which normally consist of a full exemption in the receiving State on all foreign income). Assuming that the diplomat receives income from State S, it was decided that his diplomatic privileges generated more beneficial results in State R (full exemption) compared to those derived from the application of the S-R treaty. In order not to interfere with these more extensive benefits, the treaty between States R and S needed to be left inapplicable[340]. To achieve that goal, the diplomat need not be considered a resident in the receiving State. The solution is, therefore, under the proposed rule, to deem the diplomat as a resident of the sending State only.

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333 Added in 1976, it appeared for the first time in the 1977 Model Convention.

334 Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).

335 Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).

336 Van Raad, Kees, supra note 55, at p.190. The introduction of Commentaries which are capable of modifying substantially the scope of a treaty provision is questionable, and this may be the reason why the OECD has attempted to introduce this interpretation as a mere clarification of the spirit of the rule.

337 FC/M(58)3, at p.10.

338 Working Party 14 was created between other things to deal with this issue, see FC/M(58)4, at p.11.

339 Emphasis added, see FC/WP14(59)1, at p.6.

340 Although the consideration of the diplomat as a resident would grant him access to the receiving State's treaty network, the result would not be better than the full exemption he is entitled to in that State under international law. Van Raad in fact proposes that the addition may have been made to avoid access to the treaty networks of both States, see van Raad, supra note 55, at p.188. See also to this effect the proposals made by the Delegations of Switzerland, in TFD/FC/138(1st revision), at p.1; and the proposal made by the Chairman of the Fiscal Committee and the Delegation of France in TFD/FC/139, at p.1.

While the proposal was supposed to give form to a new rule on diplomatic benefits, the German Delegation pointed out that the issue of whether the diplomat had to be considered as a resident in the receiving or in the sending State had to be dealt with in the definition of residence[341]. What the German indication seemed to suggest is that the issue was, at the outset, one of dual residence. The apparent tie needed to be broken in favour of the sending State, not to interfere with the application of the recently released Vienna Convention on Diplomatic Relations[342] in the receiving State. There was disagreement, however, as to the pertinence of such a rule in the Model[343]. The Fiscal Committee thus decided to withdraw the second paragraph of the draft rule[344], and it instructed Working Party 14 to prepare new Commentaries to explain the benefits of treating foreign diplomats as residents of the sending State. The Commentaries elaborated by Working Party 14 in 1962 took care not only of the need not to intervene with diplomatic privileges, but they also included some concerns in relation to the potential misuse of tax treaties:

> '1. The aim of the provision is to secure that members of diplomatic or consular representations shall, under the provisions of double taxation Conventions, *receive no less favourable treatment* than that to which they are entitled under international law or under special international treaties.
>
> 2. The simultaneous application of the provisions of a double taxation Convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law or under a special international treaty may under certain circumstances have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration it may be mentioned that e.g. a diplomatic agent who is accredited by State A to State B and derives royalties or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral Convention between the two States, be entitled to an exemption from or a reduction of the tax imposed on the income in State A. *In order to avoid tax reliefs that are not intended*, the Contracting States should be free to adopt bilaterally an additional provision drafted on the following lines: "Insofar as, according to fiscal previleges (sic) granted to diplomatic or consular officials under the general rules of international law or under the provisions of special international treaties, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the sending State.'[345]

If the receiving State (State B) was not prevented from recognising the diplomat as a resident, this would have generated a dual residence conflict between this State and the sending State (State A). Most probably, the tie-breaker in the A-B treaty would have operated in favour of State B[346]. As a consequence of this, the A-B treaty would have restricted the withholding tax in State A. Furthermore, all income arising from State A would have been exempt in State B, not because of the treaty but as an effect of diplomatic privileges in international law. Thus, the problem was to be solved by breaking the tie in favour of the sending State, State A.

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341 TFD/FC/140, at p.1.

342 The Vienna Convention on Diplomatic Relations (VCDR) was released on 18 April 1961. In Art.34 VCDR exempts the diplomat on all dues and taxes, personal or real, national, regional or municipal, with certain exceptions.

343 The Delegate for Ireland, for instance, pointed out that diplomats accredited to Ireland were treated as residents under Ireland's domestic law, FC/M(62)1, at p.2.

344 See FC/M(62)1, at p.3. The rule approved for discussion was: "Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules or international law or under the provisions of special agreements", which is essentially the same rule contained in Art.28 OECD Model Convention (2014).

345 Emphasis added, FC/WP14(62)2, at p.8. The new Commentaries included a proposed rule: "For the purposes of this Convention, persons who are members of a diplomatic or consular mission of a Contracting State in the other Contracting State or in a third State and who are nationals of the sending State, shall be deemed to be residents of the sending State if they are submitted therein to the same obligations in respect of taxes on income and capital as are residents of that State." The rule essentially implied that the diplomat was to be deemed to be a resident in the sending State if, regardless of being a resident in the receiving State, he was a national of the sending State and subject to tax liability in that State as a resident. The rule remains in the current Model, see Sec.1 and 2 of Comm. to Art.28 OECD Model Convention (2014).

346 Because the diplomat had a permanent home or his centre of vital interests therein.

The logical flaw of this approach, as Working Party 14 acknowledged in the rules proposed, is that it "obviously presupposes that the sending State under its national laws has a general claim to tax the income and capital of its diplomatic and consular officials stationed abroad"[347]. This, however, was not always the case, because some States treated their diplomats living abroad as non-residents. This would have ruined the solution proposed by Working Party 14, as the tie could not have been broken in favour of a State which did not sustain a general claim on the diplomat to begin with. Additional measures thus needed to be taken in order to prevent the receiving State from treating the diplomat as a resident. While the final proposal by Working Party 14 did not contain any mention to this particular problem[348], little time after a brief addition was made to the Commentaries to the definition of residence, which appeared for the first time in the Commentaries to the 1963 Draft Convention:

> 'An individual, however, is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered as a resident according to the national law and is only subject to a limited taxation on the income arising in that State.'[349]

Although to some the addition of this rule may result perplexing[350], it clearly represents a first attempt to deal with the case in which the sending State would not raise a tax claim in relation to the diplomat. The rule was considered to be a necessary complement to other provisions on diplomatic privileges that were being added to the Model[351], and its scope was therefore quite restricted. If the sending State did not claim the right to tax the diplomat as a resident, residence would have to be nonetheless denied to the diplomat in the receiving State so as to prevent the application of tax benefits derived from multiple international instruments. As Vann instinctively noticed, the rule is, in fact, at the origin of the second sentence of Art.4(1) OECD MC[352], added to the Model in 1976. What history clarifies, however, in relation to what Vann rightly observed is that 'limited taxation', as referred to in the rule, does not mean taxation as a non-resident. The diplomat was a resident in the receiving State. However, there was a certain limitation in relation to the tax base on which the tax authority of that State was exercised.

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347 FC/WP14(62)2, at p.8.

348 And in fact the mention to this flaw was carved out from the text of the proposed Commentaries, see FC(62)1, at pp.7-8, examined and approved by the Fiscal Committee in FC/M(62)2, at pp.3-5.

349 This rule appeared for the first time in Sec.10 of Comm. to Art.4 OECD Model Convention (1963), see FC(63)4 Part II, at p.11. Its use was recommended by the Fiscal Committee on 19 November 1963, see C(63)113. The rule subsists today under Sec.8.1 of Comm. to Art.4 OECD MC, and it has been attributed as a commentary to the second sentence of this rule, which was introduced 14 years after. The issue these provisions entail, however, is essentially the same. It is interesting to notice that the mention to "although *not domiciled* in that State", which Vann finds perplexing, derives from one of the original rules proposed by Working Party 14, see supra note 345. The diplomat, according to that rule, had to be a national of the sending State and thus "not domiciled in that State", that is, in the receiving State, for the rule to apply. The requirements for the provision to operate were: a) the diplomat needed to be a national of the sending State; b) the receiving State needed to tax only on the basis of source; and c) income from third States needed to be taxed in the sending State according to the tax treaties between that State and third States, see CFA/WP1(71)7, at p.13. The rule, originally contained in Sec.3 of the Commentaries to Art.27 of the 1963 Model [current Art.28], suffered later modifications. The mention to the State of domicile or nationality of the diplomat was carved out from it, but nonetheless the Commentaries to Art.4 OECD MC were never updated to reflect that change. This explains the mention to *domicile* in the current rule. See Sec.8.1 of Comm. to Art.4 OECD Model Convention (2014); and Vann, supra note 41, at p.239. For the complete history of the provision also see infra, note 362 for the original rule including nationality as a first requirement; CFA/WP1(73)1(1st Revision), at p.14 for the session in which the requirement was carved out of the rule; and the current version of the provision without the mention to nationality as a first requirement in Sec.3 of Comm. to Art.28 OECD Model Convention (2014).

350 Vann, supra note 41, at p.239. Vann in fact notices that not only the addition is in itself perplexing but also the mention to domicile, the presence of which is explained in the previous footnote.

351 Art.27 of the 1963 Draft, current Art.28 OECD Model Convention (2014).

352 When Vann carried on an exhaustive study of the history of Art.4 OECD MC, the records related to its history were available only until 1961, see Vann, supra note 41, at p.239.

7.3.1.2. Second part: After the 1963 Draft Convention and until 1977

Irrespective of this first step in dealing with the situation of diplomats, the analysis of the issue continued. Ireland, unsatisfied with the new Commentaries, introduced the first Reservation on Art.4 of the 1963 Draft:

> "Ireland cannot envisage treating as non-resident in Ireland an individual who is resident in that country under Irish law."[353]

The Delegate for Switzerland, at the same time, pointed out the insufficiency of the rules on deemed residence of diplomats being placed in the Commentaries to the Model[354]. Working Party 28[355], which took over the analysis of these rules, noticed that some States were adding provisions to their treaties to the effect of deeming diplomats as residents of the sending State. In the absence of such provisions, the question of diplomatic residence was left to Art.4 OECD MC, a result that was unsatisfactory:

> "The application of Article 4 does not as a rule involve any difficulties in bilateral relations between countries who internally apply the residence criterion referred to above and who accordingly consider foreign diplomatic and consular officials serving there as non-residents. In some Member countries, however, the domestic law decides the residence of diplomatic or consular officials differently. Such countries may, for example, consider their own officials serving abroad as non-residents and consider officials of foreign missions as residents though perhaps liable to tax only for income from sources within that country. In such cases the residence rules in Article 4 may give unsatisfactory results and create tax reliefs which are not intended."[356]

The lack of a solution to the issue of diplomats from the perspective of Art.4 OECD MC was, however, not the only obstacle the OECD had to contend with when trying to promote the use of its model rule. In 1970, the use of this rule by the different States was evaluated. In almost half the treaties tested[357], the States used a different formula:

> 'In recent Conventions, other countries have followed a similar pattern by using the formula "A resident of Country X means any person who is resident in Country X for purposes of Country X tax." [...] It is difficult to see the reasons which lie behind this trend without knowing the internal law of the different countries. However, it does seem reasonable to believe that the parties intend to avoid some undesirable tax-consequences which would arise if national administrations or courts do not agree with the Commentaries at bottom of page 67 of the Draft Double Taxation Convention on Income and Capital: "An individual, however, is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered as a resident according to the national law and is only subject to a limited taxation on the income arising in that State".
>
> Without knowing the reason, the Working Party are inclined to believe that the trend towards the formula cited above [...] arises from the fact that the nature of the liability "to taxation" mentioned in paragraph 1 of Article 4 is not defined in that paragraph. It is only when one reads the Commentaries [...] that it becomes clear that the expression "resident of a Contracting State" is not intended to include an individual who is considered as resident in that State according to its national law, if he is subject only to a limited taxation in that State on income arising there. This has led the Working Party to a consideration of the question whether

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353 C(63)87 Part II, at p.12.

354 TFD/FC/216, at p.33. It is interesting to notice that here the issue of dual residence was raised by the Delegation for Sweden, but in a completely different context, which was the Commentaries to Art.23, the rules of relief. This issue will be touched upon in following parts of this study.

355 Working Party 28 was set up at the 27th Session of the Fiscal Committee, in September 1967.

356 FC/WP28(68)1, at p.8.

357 The study was carried on ten years later and comprised conventions signed between 1963 and 1967. In 10 out of 22 treaties, the rule of treaty entitlement was substantially different. It is interesting to notice that the remaining 12 conventions were grouped under the criterion "identical or not essentially different", therefore not clarifying the cases in which the rules proposed as a model were actually acting as such. See TFD/FC/231, at pp.3-7.

any change in paragraph 1 of the Article is necessary so as to put the matter beyond doubt. *A simple change, which would appear to be effective, would be to insert the word "unlimited" before the word "taxation"* ("is liable to unlimited taxation therein")'[358].

Regardless of the fact that the proposed addition did not prosper[359], the OECD assumed that the fact that the States were not following its model rule was a consequence of something missing in the text of the Model. In 1971, Working Party 1[360] again examined the issue[361]:

> '38. Many Member countries treat diplomats, etc. sent abroad as remaining for tax purposes resident in the sending State and thus liable to tax on their world wide income. In paragraph 3 of the Commentary on Article 27 there is suggested an additional draft provision to be used in bilateral conventions between such Member countries in order to lay down that for the purposes of the convention the sending State is considered as the State of residence for diplomatic and consular officials. Such a rule would replace the provisions of Article 4 in relation to these officials and would imply that the diplomats, etc. of the sending State would be entitled to the reliefs from tax in the receiving State provided for in the convention for residents of the sending State.
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> 39. If, however, a Contracting State or both States do not treat their own diplomats, etc. serving abroad as residents, certain undesirable tax consequences may arise which cannot be remedied by the present text of the Article or its Commentary. This can be illustrated by the following example. In conventions lacking a provision of the kind referred to in paragraph 38 above Article 4 of the Draft Convention applies also to diplomatic and consular officials. Those countries which consider their diplomats abroad as non-residents normally treat under their domestic law diplomats of foreign missions in their country as residents. In accordance with general rules of international law (for instance, under the Vienna Convention), however, certain diplomats are liable to tax only on income from sources within the receiving State. If the application of Article 4 solves the question of residence of the diplomat in favour of the receiving State the result might be that income from sources in the sending State or in a third State, for instance investment income, would be left tax free or subject only to a minor withholding tax in the State where the income arises. In order to prevent such unintended tax reliefs, the Working Party would like to introduce an additional provision to Article 27 stipulating that the sending State shall be considered as the State of residence of diplomatic and consular officials.
>
> 40. However, in order to take into account also the interests of the receiving State the Working Group think there should be put in three conditions which must be fulfilled for considering the diplomat to be a resident of the sending State. The first condition is that the official may not be a national of the receiving State. Such a condition is desirable as the receiving State has the right to tax its own nationals according to the Vienna Convention. The second condition is that the diplomatic or consular official cannot be taxed in the receiving State on income from sources outside that State. The last condition should be that the official must be liable to tax in the sending State on his world-wide income. The reasons behind the two last-mentioned conditions are that if the receiving State can tax on a world-wide basis or if the sending State cannot do so, there is no cause to deviate from the ordinary residence rules, since in the first case the problems envisaged under paragraph 39 above cannot occur and in the second case the provision that the diplomat shall be considered a residence (sic) of the sending State will not solve the problem.'[362]

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358 DAF/FC/71.5, at pp.2-3. This proposal has also been analysed by Hans Pijl, see Pijl, supra note 124, at p.12.

359 The CFA in fact did no introduce any changes to Art.4 OECD MC, see CFA/WP1(71)3, at p.11; and CFA(71)10, at p.3.

360 Working Party 1 was set up at the 27th Session of the Fiscal Committee in September 1967. In June 1971, the OECD was restructured. Working Party 28 became Working Group 28, a part of Working Party 1.

361 It had committed itself to do it, see supra note 356.

362 CFA/WP1(71)7, at p.13. The rule proposed was "Notwithstanding Article 4 of this Convention, an individual who is a member of a diplomatic or consular or permanent mission of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of this Convention to be a resident of the sending State if:

(a) he is not a national of the receiving State;
(b) in accordance with international law he is not taxable in the receiving State on income from sources outside that State; and
(c) he is liable in the sending State to the same obligations in relation to tax on his total world income as are residents of that sending State".

Considering that, as was stated earlier, this part of the solution was based on the assumption that the sending State would raise a tax claim against the diplomat, and assuming it did not, Working Party 1 attempted to settle the question:

> '42. The Working Group are aware that the problem referred to in paragraph 39 cannot be solved in all cases by means of the proposed additional paragraph. In cases where the paragraph is not applicable, for instance because the sending State consider its diplomats, etc. abroad as non-residents and thus liable to tax only on income from sources in the sending State, the problem still exists. The Working Group are also conscious of the fact that there are individuals other than diplomatic and consular officials, such as, e.g. employees of international organisations, who enjoy exemptions from tax on foreign income. The application of Article 4 of the Draft Convention would in the cases mentioned lead to such unsatisfactory tax consequences as are referred to above. The Working Group therefore think that it is necessary to modify the provisions of paragraph 1 of Article 4. *The modification should imply that the ordinary method for determining residence under the Convention, by means of domestic law, shall not apply in relation to such individuals who under the law of a Contracting State are held liable to tax only on income from sources within that State in spite of the fact that they are under the same law considered as residents of that State.*
>
> 43. The Working Group are of the view that the present problem can be solved by an addition to paragraph 1 of Article 4 and submit for consideration the text of that paragraph as amended (the proposed addition is underlined):
>
> > "For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, <u>but the term does not include any individual who is liable to tax in that Contracting State for the sole reason that he derives income from sources therein</u>."'[363]

Two years later, an almost definitive version of the rule was approved:

> "[…] but the term does not include any *individual* who is liable to tax in that Contracting State in respect only of income from sources therein."[364]

Although the scope of the rule was clearly limited to individuals (diplomats), its final version was approved by using the term 'person'[365]. This, however, was more a coincidence than a well thought-out decision[366]. Still, this wording has been quite convenient for the later interpretation of the rule by the OECD. Under its current version, to which the Commentaries added in 1963 have at a later time been attributed[367], Art.4(1) second sentence of the OECD MC states:

> "This term [the term resident of a contracting State] however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."[368]

7.3.2. Precise scope and spirit of the provision proposed

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363 Emphasis in italics added, underlined text is original. CFA/WP1(71)7, at p.13.

364 Emphasis added. CFA/WP1(73)1, at p.12.

365 See Art.4 OECD Model Convention (1977).

366 In some of its reports Working Party 1 used the word 'individual' and in others the term 'person', and apparently there was no particular reason to use one or the other, see CFA/WP1(73)1, at p.11, in para.26 uses the term 'person' and then in para.29 uses 'individual'; in CFA/WP1(73)1(1st Revision), at p.13, para.25 again refers to 'persons', while in para.28 referring to 'individuals' once more; in DAF/CFA/WP1/73.5, at p.5 it was ordered to substitute 'person' for 'individual' in the proposed text of Art.4; and finally, the first draft of Art.4 with the new second sentence was approved with the term 'person', in CFA/WP1(73)5, at p.2.

367 The OECD accepted that the issue had already been dealt with in the Commentaries of the 1963 Draft Convention, see CFA/WP1(73)1, at p.12, as Vann had proposed, see Vann, supra note 41, at p.239, and so it attributed those Commentaries to the second sentence. They appear in Sec.8.1 of the Commentaries to Art.4 OECD Model Convention (2014), with an express reference to the second sentence.

368 Art.4 OECD Model Convention (2014).

As the OECD acknowledged after having approved the proposal, the objective of the system of rules of which this second sentence formed part, "was for each receiving State to exclude, in principle, from the benefits of the Convention all persons other than its own diplomats."[369] The solution was meant to operate in the precise bilateral context where each State had sent diplomats to the other contracting State, and it was subject to the tax treatment received by the diplomat in that State.

It is thus clear that the new sentence was not meant to establish a principle of residence in itself, but it was only meant to operate as a last resort in order to solve a very precise problem: Each State with which the diplomat had a relation renounced its right to tax his income on the basis of different international instruments[370]. While the full exemption granted to the diplomat in the receiving State under international law was already quite advantageous, to recognise the right of this individual to use, on top of those benefits, the rules of the OECD MC to further restrict the withholding tax at source in the sending State[371] may have seemed to be excessive.

To avoid the use of the Model in these cases, the diplomat had to be deprived from the recognition as a resident in the receiving State. Such a conclusion, however, could not have been reached by simply stating that the diplomat was not subject to *enough tax*[372]. It was reached by breaking a tie in favour of the sending State. The solution was nonetheless inefficient if that State did not claim the right to tax the diplomat as a resident, because the tie could not have been broken in its favour. Only in that exceptional case, which demanded the analysis of the situation from the perspective of both States, to prevent the combined use of the OECD MC with other international agreements providing tax benefits, the exception was set up. The purpose of the second sentence was that, if all else failed, the diplomat, although a resident under the laws of the receiving State, was not to be considered as such for the purposes of the treaty.

7.4. Tax liability and residence after the second sentence

7.4.1. Introduction

The addition of a second sentence to Art.4(1) OECD MC seems to have changed the conceptualisation of 'full' and 'limited' tax liability, or at least it so appears from literature. Under the old concepts, a partially exempt entity was clearly 'fully liable to tax' because it was taxed on the basis of a personal attachment. Under the new rule, however, to some the restriction of the tax base in such a case would be capable of generating a 'limited tax liability', capable of preventing the operation of the agreement.

The basic problem this interpretation entails is the determination of 'full tax liability' for the purposes of the application of the treaty. If one assumes that a person who is not taxed on all his income should be excluded from the application of the treaty because he is not 'fully liable to tax', then there would be little reason not to conclude that the same effect would be caused by reduced rates, deductions, allowances, and many other factors. This would logically lead to endless

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369 DAF/CFA/WP1/72.9, at p.4.

370 Either the OECD MC, the VCDR, or other particular international arrangement.

371 Kees van Raad has suggested that this was done to prevent access to State R's treaty network, see van Raad, supra note 55. The debate at the OECD, however, was restricted to the bilateral relation between the sending and the receiving State, and the effects of the combined application of the VCDR and tax treaties in that scenario.

372 As the history of the Model so neatly demonstrates, by that time it was relatively clear that effective taxation was not a condition for treaty benefits to arise, see infra, Chapter 8.

discussions, reducing the utility of the terms in describing a tax liability capable of giving rise to treaty entitlement, which is essentially what actually happens at the level of literature and case law. However, there appears to be little clarity as to the effect of this second sentence and in relation to the meaning of the expression 'full tax liability'. An effort must therefore be made to identify the impact of the addition in the meaning of those expressions.

7.4.2. Limited tax liability vs. liability which is limited to certain income

It is clear from history that the second sentence sought to restrict the application of the Model when a diplomat, due to the application of international laws, was "only subject to a *limited taxation on the income* arising in that State"[373], meaning the State receiving him. The solution was nonetheless subject to the condition of a certain tax treatment in the other State relevant for the purposes of the rule, the sending State. In one of its explanations, however, Working Party 1 unfortunately stated:

> "Thus agreement seems to prevail among Member countries, that individuals treated as residents under domestic law but only subject to *limited tax liability* shall not be considered as residents under the Convention."[374]

According to what has been stated earlier, until 1963 there was a clear difference between 'full', 'comprehensive' and 'unlimited' tax liability on the one hand, and 'limited' tax liability on the other. While the former was imposed on the basis of a personal attachment, the latter was defined in attention to the income received by the person, regardless of any personal relation with a State (taxation of non-residents). The case of a diplomat, however, was an intermediate case: a person who, although a resident (full tax liability), was nonetheless subject to taxation only on certain items of income arising in a State. The OECD referred to this case as 'limited tax liability'.

Although it may be tempting to qualify the tax liability of a diplomat as 'limited', it is relatively clear that one would be changing the meaning of 'limited tax liability' as used in the Model before the second sentence. If 'limited' tax liability refers to the case of a resident who is taxed only in respect of certain flows of income, then 'unlimited' may refer to the tax rate as much as 'comprehensive' may refer to the tax base[375], and this is not correct[376]. This was clearly not the intention behind the new rule, which makes the vocabulary used in the OECD's explanations unfortunate. The case of a diplomat was one of full tax liability, with a limited tax base due to international privileges. His situation, however, was not of 'limited tax liability' at all.

While the difference between 'limited tax liability' and 'full tax liability limited to certain income' may appear to be insignificant[377], many conflicts in literature depart from the vague borders of this distinction. A conduit company, for instance, may be liable to tax only on income from sources in a State. Yet, if it is said that such a company is subject to 'limited tax liability', that argument is immediately debatable because the company does have a personal link with a State in which taxation has been triggered. A conduit is, evidently, a resident (subject to full tax liability) in that

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[373] Emphasis added. See supra note 349. See also CFA/WP1(71)7, at p.14. In the Commentaries to the 1963 Draft Convention the expression used was "limited taxation on the income arising in that State", see C(63)87 Part II, at p.11. An equivalent expression, 'taxation limited to the income from sources in that State', is used under the current Commentaries, see Sec.8.1 of Comm. to Art.4 OECD Model Convention (2014).

[374] CFA/WP1(73)1, at p.12, para.29. The same wording is used in CFA/WP1(73)1(1st Revision), at p.14, para.28.

[375] Couzin, supra note 20, at p.151.

[376] This in fact generates confusion: 'the terms "limited" and "unlimited tax liability" refer to worldwide income', see IBFD Comment on Germany, Federal Tax Court, 29 January 2003, *Case I R 6/99*.

[377] It may be argued that for practical purposes there is little difference between begin 'fully liable to tax' although subject to an exception, than being subject to 'limited tax liability'.

State. The case of a resident of a State which loses the tie-breaker is similar. After the tie has been broken, the person may be subject to taxation only on income from sources in that State. The relevant question, though, is not whether he continues to be a resident in that State, because the rule somewhat assumes he does. The proposal by the OECD was not supposed to exclude a diplomat from the application of the treaty between the receiving and the sending State because he was not a resident of the receiving State anymore. On the contrary, its aim was to set an exception to the use of that treaty in such a special case, because the recognition of those benefits seemed excessive[378].

A diplomat, however, did not need to be treated as a non-resident in the receiving State at the domestic level in order to be excluded from the Model according to the rule, which means that he may have had the right to use deductions, allowances, and other rights. If he were in fact treated as a non-resident in that State, he would properly be referred to as subject to 'limited tax liability'. Yet, in such a case he would be excluded from the treaty due to the first sentence of Art.4 OECD MC and not according to the second. The same would apply in the case of a dual resident. If such persons were treated as non-residents in the State which loses the tie, then such persons would not be treaty residents under the first sentence, and not according to the second[379]. The second sentence was neither meant to modify the meaning of 'limited tax liability' as conceived before 1963, nor to alter the status of the diplomat as a resident of the receiving State. As a matter of fact, the OECD explained repeatedly that if the sending State subjected the diplomat to full tax liability, that is to say, if it did not renounce to treat him as a resident, the application of the second sentence in the receiving State was unnecessary.

7.4.3. The meaning of unlimited tax liability after the addition

As a confirmation of what has been stated in relation to 'limited tax liability', the OECD expressed its views on the situation of officials of international organisations. They frequently enjoyed exemptions from tax on their foreign salaries[380], although not necessarily on the rest of their income. The question was raised as to whether these persons could be considered to be covered by the principle of 'unlimited tax liability'[381]. The Delegate for France observed that this would only be possible to the extent that the relevant income was included in their tax base when applying the exemption with progression method. The Working Group 28, however, stated:

> "The Working Group do not share the opinion of the French Delegation. Some categories of taxpayers, other than officials of international organisations, enjoy in certain respects tax reliefs under domestic law in their State of residence. It does not follow as a necessary consequence that the relief is taken into account for determining the rate of tax on other income. *Neither can it in the Working Group's view be argued that they should not have the benefit of Conventions concluded by the State where they are residing*."[382]

The views of the OECD in this respect were consistent with the rules of the Model in relation to taxation as a condition for tax treaty benefits. As will be explained in a subsequent part of this study[383], myriad arguments support the conviction that effective taxation is in no way required to access the benefits of the Model. The absence of taxation in relation to certain flows of income, as salaries, does not restrict the existence of 'unlimited', 'comprehensive' or 'full' tax liability. Not

378 Considering that the individual was exempt on all foreign income in the receiving State, it may have seemed excessive to further recognise its ability to restrict the rates of tax at source in the sending State through the use of the treaty.
379 Van Raad, supra note 55, at p.188.
380 CFA/WP1(71)7, at p.14.
381 The question was raised by the Delegate for the Netherlands, see DAF/CFA/WP1/72.9, at p.4.
382 CFA/WP1(73)1, at p.13; ratified by Working Party 1 in CFA/WP1(73)1(1st Revision), at p.15.
383 This will be explored in detail in Chapter 8.

even the absence of taxation on all income is able to provoke such an effect. The application of the second sentence requires more than the absence of taxation in the alleged State of residence.

7.4.4. The Crown Forest case and the 'most comprehensive' tax liability

The Supreme Court of Canada had the opportunity to deal with some of the issues related to the second sentence of Art.4 OECD MC in the *Crown Forest* case[384], in the context of a treaty in which, paradoxically, the second sentence had not been included. Norsk, a company incorporated in the Bahamas, had an office in the US engaged in trade and business from where the company was in fact managed. By arguing that Norsk was a resident in the US for having a place of management therein, the company claimed the application of the reduced withholding tax for profits sent to Canada, under the US-Canada tax treaty. The claim was nonetheless dismissed by the court, because:

> '[...] the criteria for determining residence in Article IV, paragraph 1 involve more than simply being liable to taxation on some *portion of income* (source liability); they entail being subject to *as comprehensive a tax liability as is imposed by a state.*'[385]

The court pointed out that Norsk was not a resident in the United States because the company was not subject to 'as comprehensive a tax liability as imposed by a State'. In reality, according to what has been said so far it would have been enough to state that Norsk was not subject to 'full' or 'comprehensive' tax liability, meaning that the company was in fact treated as a US non-resident. The manner in which the ruling was drafted, however, suggests the existence of different degrees of full tax liability for the purposes of defining tax treaty entitlement: one that is less and another that is more comprehensive[386].

The issue at the heart of the Crown Forest case, however, involved a company that was subject to 'limited tax liability' (implying non-resident taxation), and not to full tax liability limited to income from sources in a State, as in the second sentence of Art.4 OECD MC. Norsk was clearly treated as a US non-resident under US tax law, taxable in the US only because of certain flows of income arising therein, and not due to a personal attachment based on those laws. The ruling contributed to the already confusing context of the rule, by giving the appearance that Norsk was found not to be a resident for the purposes of the treaty because only part of its income was subject to a tax liability in the US, meaning the income arising in the US. Yet the reason for the exclusion lied in the absence of a tax liability under the domestic laws of the US, as defined in Art.4 OECD MC (personal attachment).

This suggests that, contrary to what has been argued[387], the lack of a second sentence in Art.4 of the US-Canada tax treaty was in fact irrelevant for the purposes of the case's outcome. Norsk was not entitled to the treaty because of the first sentence of the rule and not because of the second.

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384 *Crown Forest*, supra note 13. Several aspects of the Crown Forest case are also explored in Chapter 3, at pp.29ff and Chapter 5, at pp.51ff. For an analysis of the case see Ward, supra note 13, at pp.408-424.

385 Emphasis added. *Crown Forest*, supra note 13, at p.821.

386 It is interesting to mention, as Ward points out, that the expression 'more' (as in 'a more comprehensive liability to tax') was dropped from the two sections in which it was mentioned in the Commentaries, one in 1963 and the other in 1977. The Supreme Court of Canada did not, however, explain the effect of these changes. See Ward, David, 'The Use of OEEC-OECD Historical Documents in Interpreting Tax Treaties', in in Baker, Ph., et al., (eds.), *Tax Polymath*, (Amsterdam: IBFD, 2010), at p.14; and also Vann, supra note 41, at pp.232-233.

387 Vann in fact suggests that the absence of the second sentence may have had an influence in the fact that two lower courts in Canada gave reason to the allegations of Norsk, see Vann, supra note 41, at p.248.

The company was subject to 'limited tax liability' in the US[388], for it was a non-resident taxpayer therein. On the contrary, if from the facts the conclusion had been drawn that Norsk was a resident in the US, a partial exemption would not have had enough merits to exclude the company from tax treaty entitlement. In that case, it would have been clear that the company was a resident domestically, only subject to a partial exemption. This, however, would not have changed the fact that Norsk was, despite the exemption, subject to 'full' tax liability. Hence, even if the second sentence had been included in the treaty, its analysis would not have been pertinent in that particular case.

7.4.5. Evaluation: The second sentence and tax liability in the Model

It is clear that the terms 'full, 'comprehensive' and 'unlimited' tax liability are not different terms, but they represent the same thing: tax liability based on a personal attachment with a certain State. They do not refer to the tax base, to the tax rate, or to any element other than the person itself in its general submission to the tax authority of a State. They do not entail any sort of necessity of an economic nexus between the claimant and the State in which treaty benefits are requested. A simple nexus, resulting in a situation in which the State extends its tax jurisdiction over the person on the basis of personal factors, is enough[389]. On the other hand, 'limited tax liability' refers to the case of a person who is subject to the tax authority of a State only as an effect of having income arising from sources therein, regardless of any subjective connection between the person and the State. The case of a person who is partially exempt from tax is, accordingly, still one of 'full' tax liability.

The second sentence of Art.4 OECD MC has not introduced any changes to the conceptualisation of 'limited' and 'full' tax liability, as it existed before 1963. Its addition was meant to create an exception to the rule of 'full' tax liability[390], justified by the interaction of the Model with other international rules. Yet it does not seem that the second sentence was meant to create a principle of residence on its own, but it was only supposed to be applied when the circumstances in both States so required. A diplomat had to be considered to be a resident, fully liable to tax in the receiving State, but nonetheless exempt on all foreign income due to another international instrument, to justify its application. This, however, on the condition that the sending State did not sustain a claim based on residence on the same person, case in which the tie-breaker would have to be broken in its favour. It is relevant to highlight that if the laws of the States follow the suggestions made by the OECD in their domestic laws so as to treat foreign diplomats as non-residents, those persons would not be excluded from the Model by the second sentence. They will be considered to be subject to 'limited tax liability' under the first sentence, and thus excluded through the main principle of treaty residence.

7.5. Applying the second sentence to exclude conduits and dual residents

7.5.1. Introduction: The new spirit of the second sentence

Two fundamental additions have been made to the Commentaries to Art.4 OECD MC in 1992 and 2008, which give form to its current wording:

388 The aspects in which the lower courts erred were not related to the lack of appreciation of the situation of Norsk as a non-resident, but to the incorrect assimilation of its circumstances to a criterion of a similar nature under Art.4 OECD MC, see supra Chapter 5, at pp.57ff.

389 See de Graaf, supra note 208, at p.173.

390 Van Raad, supra note 55, at p.188.

> "According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, while being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States."[391]

The Commentaries set out a deviation from the original rule and this presupposes the attribution of a totally new spirit to the second sentence in Art.4 OECD MC. As will be discussed hereunder, this interpretation modifies the factual basis on which the rule has to be applied. Moreover, it also suggest that the spirit of the second sentence of Art.4 OECD MC is capable of excluding these cases from the application of the Model as if their exclusion had always been within the expected scope of the rule. There are nonetheless quite a number of clarifications to be made in relation to the position adopted by the OECD in the new version of the Commentaries.

7.5.2. Conduits and dual residents: A new interpretation for an old story

7.5.2.1. Introduction

The interpretation of the Model in 1992 and 2008 has allegedly clarified the implied meaning (and spirit) of the second sentence. From an historic perspective, however, this is incorrect. The issue of conduits and dual residents were discussed during the process that resulted in the addition of new Commentaries in 1963 and a new sentence in 1977. Yet the working groups within the OECD never saw the link between all those issues. For the duration of the debate, almost twenty years[392], those situations were simply and clearly ignored as being outside the scope of the new rules.

7.5.2.2. Conduit companies and tax treaty abuse

The situation of conduit companies, added to the Commentaries in 1992, was examined for the first time in 1962. At that time, it was pointed out that "[t]hrough the establishment of related corporations in several countries, often for no purpose other than the anticipated tax benefits, taxpayers in treaty countries have taken advantage of international tax agreements"[393]. Although there was no clarity as to what treaty abuse actually meant[394], the belief grew that the OECD had to "consider particularly the use of such entities as base companies"[395].

The Fiscal Committee examined these concerns and instructed the creation of a new working group to deal with them. It is quite interesting to note that the records of the relevant session, held in 1962, reveal that the subject of diplomats was dealt with in the same meeting. No one, however, noticed the connection between these issues[396]. In 1963 an addition was made to the Commentaries stating the exclusion of persons whose tax liability was restricted only to income

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[391] Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).
[392] The discussions on treaty abuse were held from 1958 to 1977. This period, of course, does not include the time it took for the additions to be made to the Commentaries to the Model itself, which occurred in 1992 in the case of conduit companies, and in 2008 in the case of dual residents.
[393] TFD/FC/136, at p.1.
[394] FC/WP14(62)4, at p.2.
[395] TFD/FC/141, at p.1.
[396] FC/M(62)1, at pp.2-6.

arising from sources in a State[397] (diplomats). Yet the issue of conduit structures was, at that time, a "new and complex question" which needed to be postponed for a later time[398].

Working Party 21 continued to examine the situation of base companies[399], and so did the Fiscal Committee[400]. In none of those meetings, however, were these issues linked to the intense and simultaneous discussion held in relation to diplomats. Although the debate in relation to conduit structures was not unbeknownst to Working Party 1, the records on the discussion on the second sentence of Art.4 OECD MC make no mention of this issue[401]. When the new second sentence was finally added to the Model in 1977 and the Commentaries were modified so as to attribute the prior mention of this issue to the new rule[402], no connection was perceived between the addition and the discussion held at Working Party 21.

In 1986, when the OECD's concerns about treaty shopping and treaty abuse took a somewhat more defined position[403], it was stated that the second sentence entailed an anti-avoidance provision[404], which was capable of dealing with the situation of conduits as well. The addition to the Commentaries was finally carried out in 1992. A few years later, and probably frustrated by the insufficiency of the measures taken by the OECD to deal with the issue, the main promoter of the subject, the United States, took a different path. In 1996, the US Model Convention was released. An extensive limitation-on-benefits provision was devoted, amongst other things, to the situation of conduits[405].

7.5.2.3. Residents of a tie-breaker loser: After 44 years of analysis

The need to exclude from the application of the Model residents of a State which has lost a tie-breaker was introduced to the Commentaries in 2008[406]. Yet, this issue was raised as early as in 1964, when the Japanese Delegation sent some questions to the Fiscal Committee. While some of them explored the interaction between Art.1 OECD MC and the rest of the Model, most of the communication referred to certain aspects of the definition of residence:

> '2. Suppose the case where a person who is a resident of both of the Contracting States A and B under respective domestic laws (hereinafter called "taxpayer") is deemed as a resident of State B for the purposes of the Tax Convention between State A and State B. How shall State A solve the following problems that may arise in the application of its domestic tax laws? Namely: [...]
>
> (2) Whether State A should treat "taxpayer" as a resident of State A for the purpose of its own taxation on condition that it grants him all the benefits for a resident of State B stipulated in the Convention, or State A should treat "taxpayer" wholly as a non-resident. If "taxpayer" should be treated as a non-resident, "taxpayer" might suffer from a disadvantage in a certain case because of the non-applicability of personal deductions or the application of flat tax rate. Should this disadvantage be considered as an inevitable consequence of the

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397 See the final part of Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).

398 "The Chairman said that this was a new and complex question which could not be dealt with in the draft Convention to be submitted to the Council by July, 1963. The Committee shared this view", FC/M(63)2, at p.3.

399 TFD/FC/183, at p.2, see in particular paragraph (f): 'Suppose "A" has several operating subsidiaries in various foreign countries. It established "B" to hold the stock in those subsidiaries and "B" receives the dividends declared by them and invests such dividends in various ways."

400 DAF/FC/69.13, at pp.6-7.

401 CFA/WP1(73)1(1st Revision), at pp.13-16.

402 CFA/WP1(73)1(1st Revision), at p.10.

403 See OECD, Report on base companies, supra note 280; and OECD, Report on conduit companies, supra note 280.

404 OECD, Report on conduit companies, supra note 280, at p.9.

405 See the limitation-on-benefits provision in Art.22 of the US Model Convention (1996).

406 OECD, *The 2008 Update to the OECD Model Tax Convention*, (Paris: loose-leaf, 2008), at p.6.

> application of Article 4? Or is it necessary for State A to give him option to remain a resident of State A for the taxation purposes?'[407]

These concerns were upheld by the Delegation of Sweden in 1967, when the States had the opportunity to send their comments on the 1963 Draft Convention:

> "In paragraph 2 of Article 4 rules are given with the intention to solve cases of double residence of individuals. However, quite a few cases have occurred where a taxpayer, who according to Swedish law is clearly resident in Sweden, is considered, for the purposes of a tax convention with another contracting State, as a resident in that State. In these cases the result sometimes has turned out to be unsatisfactory from the Swedish point of view, especially with respect to recent legislative measures introduced in order to counteract tax evasion by means of a transfer of residence."[408]

Four years after having received the Japanese communication and despite the observation made by Sweden, in 1968, Working Party 28 only explored the relation between Art.1 OECD MC and the other rules of the Model[409]. The exclusion of a person having lost a tie-breaker through the rule for diplomats was not examined, although the same working group was also in charge of the question of diplomats[410]. Further, in 1973, the issue of diplomats was again described so neatly and with such enough detail that the link between one issue and the other could not have gone unnoticed[411], unless it was purposefully ignored. Working Party 1[412], however, did not even mention the case of the tie-breaker loser, as the conviction existed that the scope of the rules was simply different.

In 1973 the second sentence was already a part of the new draft Art.4 OECD MC[413] and later, in 1975, the situation of the tie-breaker loser continued to be analysed[414]. It was in this year that the OECD finally gave a response on the basis of the definition of residence to this issue[415]:

> '5. Each of two Contracting States may subject, under its internal law, the same person to unlimited tax liability, either as a resident of such State, or exceptionally as a national thereof. The Draft Convention aims at avoiding the situation that such person continues to be subjected in both States to tax in his total worldwide income and capital: Under Article 4 of the Convention the person will be considered, for the application of the Convention as a resident of State A only. The intention is that the other Contracting State B should be precluded from taxing income or capital for which the Convention gives the right to tax to the State of residence [...].

407 TFD/FC/173, at p.2.

408 TFD/FC/216, at p.27. The observation was attached to Art.23 on the methods of relief due to the fact that Sweden had dealt with this issue by introducing a special rule in its tax treaty with Switzerland reserving "the right to tax an individual who according to Swedish legislation is resident in Sweden but who according to the Convention is resident in the other contracting State". Switzerland, its treaty partner, introduced an observation to Art.27 on diplomatic privileges, stating the need of such rules in the text of the Draft Convention. Notwithstanding the clear opportunity to notice the connection between these two issues, no comments were raised in relation to that, see TFD/FC/216 at p.33.

409 FC/WP28(68)2, at pp.1-5. In fact, there is only one reference to the document sent by the Japanese Delegation, at p.2, which under the title "Consolidated List of Outstanding Points" clarifies: 'The points listed in this document are the points arising from the observations of the Japanese delegation: "On what other Articles if any should Article 1 have a limitative effect"'. The question of dual residence was disregarded as a relevant point.

410 The records of those sessions were titled: "Working Party No. 28 of the Fiscal Committee. Second report on articles 1, 4, 14 to 20 and 21, and questions concerning annuities and residence of diplomats", see FC/WP28(68)2, at p.1.

411 CFA/WP1(73)1(1st Revision), at p.13-16.

412 Working Party 1 was set up at the 27th Session of the Fiscal Committee in September 1967. In June 1971, the OECD was restructured. Working Party 28 became Working Group 28, a part of Working Party 1.

413 Already in 1973, Art.4 of the 1977 Model Convention stated: "[...] but the term does not include any person who is liable to tax in that Contracting State in respect only of income from sources therein or capital situated in that State", CFA/WP1(73)5, at p.2.

414 CFA/WP1(74)2(1975), at pp.1-2.

415 CFA/WP1(75)5, at p.2.

> 6. One solution would be to state in Article 23 or 23A or 23B quite generally that the income derived or capital owned by a resident of a Contracting State shall be exempt from tax in the other Contracting State, except where another Article of the Convention expressly provides for taxation of such capital or income in the State which is not the State of residence. The same goal could be achieved by inserting in paragraph 1 of Article 4 after "For the purposes of this Convention" the words: "and the internal law of the Contracting States".'[416]

This statement was made in the context of a draft rule that already included the second sentence and also Commentaries in the same line, which had been added twelve years before. Yet, the OECD not only ignored the issue from that perspective, but it acknowledged two things: Firstly, that the core of the problem was one to be solved by the domestic laws of the States; and secondly, that the Model lacked the elements to deal with this case. As a matter of fact, in 1999 there was agreement on the fact that not even the Commentaries to the Model were able to support this interpretation, which was "generally thought to be wrong"[417]. It is thus fair to wonder what the difference was when, forty-four years after the issue was proposed, in 2008 the OECD so resolutely changed the Commentaries to include such an interpretation of the rule[418].

7.5.2.4. Evaluation: The timeline of the OECD's concerns

It is interesting to analyse the timeline of the OECD concerns. The first milestone in this process is the rise of the issue of diplomats in 1958. In 1962, the US Delegation sent some ideas in relation to tax avoidance that put the conduit issue on the table. The OECD modified the Commentaries to Art.4 OECD MC in 1963 in order to clarify that persons whose tax liability was limited to income from sources in a State were not to be considered as treaty residents. Yet, this change did not refer to conduits. Further, in 1964 Japan and in 1967 Sweden presented the fundamental question of dual residence in a way that is unmistakably identical to the concerns which gave place to the addition in 2008. Nonetheless, the OECD ignored this issue, or at least it never gave it any consideration from the standpoint of the second sentence. It is especially relevant to acknowledge that all these concerns were gathered, at a certain point in time, in the same working group[419]. They were, regardless of their apparent identity, never mixed up.

This timeline logically clarifies that the issue of conduit companies and dual residents never played any role in the discussion which led to the addition of a second sentence to Art.4 OECD MC. A careful review of all the different records of Working Party 28[420] demonstrates that there is not a single reference to these issues, although most of these observations were of its competence. Finally, after thirty years in the case of conduits[421] and forty-four years in the case of dual residents[422], the OECD felt the urge to clarify that these exclusions were contingent with *the spirit* of the rule. History nonetheless demonstrates that the motivations behind the addition of the second sentence are rather different that those which led the OECD to change the rule in 1992 and 2008.

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416 CFA/WP1(75)5, at pp.2-3.

417 In 1999, Avery Jones and Bobbett summarised the conclusions arrived at by Seminar E at the IFA Congress in London, in relation to triangular treaty problems, and they analysed the position of the Netherlands Ministry of Finance in relation to the tie-breaker in order to reach these conclusions. See Avery Jones, John, et al., 'IFA: Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London', in 53 *Bulletin for International Taxation* 1 (1999), at p.19.

418 OECD, *The 2008 Update to the OECD Model Tax Convention*, (Paris: loose-leaf, 2008), at p.6.

419 Working Party 1 was set up at the 27th Session of the Fiscal Committee in September 1967. In June 1971, the OECD was restructured. Working Party 28 became Working Group 28, a part of Working Party 1.

420 Working Party 28 replaced Working Party 2, see FC/WP28(68)1.

421 Considering the time from which the issue was raised (1962) until its addition to the Model (1992).

422 In 1964 the Japanese Delegation raised the issue, and in 2008 the new rule was added to the Model.

7.5.3. Conduit companies, abuse of treaties and the second sentence

Regardless of its history, one can make the effort to test whether the solution contained in the second sentence is compatible with the *factual* situation of conduits. The original scope of the rule requires looking at the State in which the conduit is located (State R), but also to those States from where the conduit obtains its income (State S). The literal application of the rule would require two things: Firstly, that State R considers the company as a resident but nonetheless exempts that company on all its foreign income on the basis of international law; and secondly, that the other contracting State (State S), does not raise any claim on the basis of residence in relation to the conduit company.

Seen from that perspective, it appears that in principle the factual scenario coincides with the concerns expressed in the original rule, although instead of international law the additional benefits are granted at the domestic level. Certain States design tax benefits in order to attract foreign direct investment. These holding companies often obtain tax-exemptions for all foreign sourced income. Even though the issue in a way coincides, one cannot but wonder where the ultimate source of the problem lies, that is to say, the reasons that make those treaty benefits *improper*. When looked from that angle, the situation of diplomats and conduits differ essentially.

One could argue that the rule aimed at avoiding double non-taxation. Yet, history demonstrates that its primary purpose was not to interfere with the fiscal privileges which, in the case of diplomats, secured a full exemption of their income[423]. The fact that certain treaty benefits seemed excessive did not imply that non-taxation was being avoided. After all, if the exemption had been granted by reason of domestic law instead of international law, there is no doubt that the State of source would have been restricted by the treaty. This is in fact consistent with a Model which does not require effective taxation for its rules to apply in each State[424].

The potential for non-taxation at the core of the issue of conduits did not seem to be the problem. Those benefits were seen as improper because a company is set up only for the purposes of obtaining them. No one would ever think that a diplomat has become a diplomat only to the effect of obtaining certain tax reliefs, but the situation is different in the case of a conduit. A company can indeed be established with the sole purpose of obtaining tax advantages. It is the artificial character of the structure which, at the outset, is debatable.

If the question were raised of whether that objection finds a place in the second sentence of Art.4 OECD MC, the answer appears to be negative. The inclusion of the rule did not entail a real effort to deal with treaty abuse. This is probably the reason why the US abandoned the debate at a certain point and took a separate and more decided path, one that has been reconsidered by the OECD in the context of BEPS in 2015[425], after so many years. The second sentence of Art.4 OECD MC is not only weak for such purposes, but it simply does not challenge abuse from a proper angle, which is the absence of a relevant economic nexus. Further, the rule is especially inefficient in a Model in the context of which there are many doubts as to the role of effective taxation for treaty benefits to arise[426]. After all, there seems to be no difference between a company that is

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423 FC/WP14(59)1, at p.6.

424 See infra, Chapter 8.

425 In the context of the BEPS project, a limitation-on-benefits rule has been proposed, see OECD, Public Discussion Draft, BEPS Action 6, supra note 27. The final version of the rule was proposed in October 2015, see OECD, Action 6: 2015 Final Report, supra note 1, at p.21ff. This new rule is further explored in Chapter 11.

426 See infra, Chapter 8.

partially exempt (as a conduit) and another that is fully exempt. If the Model does not deny treaty entitlement to the latter, it seems unreasonable to suggest that it rejects it in the case of the former. Yet this is the manner in which the OECD has decided to confront the issue.

7.5.4. The second sentence and residents of a State losing a tie-breaker

The first explanation of the issue of diplomats was a perfect dual residence scenario: the diplomat was considered to be a resident in the sending State (State S) and also in the receiving State (State R). While residing in State R, he received income from State S. In addition to the full diplomatic exemption in State R, he was able to reduce the rates of taxation at source, in State S. In order not to restrict those rates, the tie needed to be broken in favour of State S. Only if State S did not raise a claim based on residence on the diplomat, the second sentence had to prevent him from ever claiming the benefits of the S-R treaty as a resident of R.

The OECD MC lacks a proper tie-breaker for diplomats and perhaps it should have dealt with the issue of diplomats through a tie-breaker and not through the second sentence, but that is not the issue at this point. For the second sentence to apply in a common dual residence scenario the basic requirements are: Firstly, while being a resident in State R, the person must be subject to a full exemption on all foreign income; secondly, the person must be receiving, at the same time, income from sources in State S; and thirdly, State S needs not to raise any tax claims based on residence in relation to this person. Only then it would be appropriate to prevent the person from using the S-R treaty to reduce source taxation in State S.

It is fairly evident that the scope of the rule and the dual residence conflict do not match. The new interpretation of the OECD in order to extend the second sentence to dual residents is somewhat redundant: it implies that after having applied the tie-breaker in favour of State S, the person needs not to be considered to be a resident in State R for the purposes of the treaty, which seems to be the effect of the tie-breaker in the first place. For the purposes of the S-R treaty, the person will not be able to claim the benefits of that treaty in State R as a resident because the tie has been broken in favour of State S, *ergo*, the applicability of the S-R treaty to reduce source taxation in State S has already been prevented.

Thus, the purpose of this new interpretation was not really to prevent the application of the S-R treaty, for that would have been pointless. What the OECD has really tried to do is to introduce an interpretation of the rule as an all-purpose anti-avoidance provision, which was meant to exclude a dual resident who loses a tie-breaker from the application of any other tax treaty[427]. The reason behind this exclusion was probably the assumption of a tax avoidance motivation behind the acquisition of a double residence. Yet, while the problem seems to rest on the authenticity of the situation, the rule does not really question that. The debate is commonly focused on the possibility of a treaty generating effects on other treaties (and the means to do so), and not on the presence of abuse in a dual residence situation.

One needs to understand that, in the current context, this is not a question of the OECD MC having an impact on the conceptualisation of residence at the domestic level. The OECD long ago accepted

[427] Boccardo, Valentina, 'Dual resident corporations and the changes in the Commentary to the OECD MC 2008 – impact on existing treaties', in Hofstätter, Matthias, Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at p.129.

that the Model does not have that authority[428]. Some States have opted for treating tie-breaker losers as domestic non-residents[429], which is a way of dealing with the uncertainty generated by the need to treat domestic residents as treaty non-residents[430]. Yet, if a State treats a dual resident loser as a non-resident under domestic law, such person is subject to 'limited' tax liability in that State and it is thus excluded from any treaty under the general rule of the first sentence.

The second sentence under the new interpretation by the OECD has gone one step further. It has stated that a tie-breaker loser is not subject to comprehensive tax liability, which is incorrect unless the domestic laws of a State treat the person as a non-resident. By doing so, it again has provided the idea that 'comprehensive' tax liability depends on the tax base, for the original exclusion referred to a person who was partially tax-exempt, which is also erroneous. The rule attempts to suggest that a person who is a resident domestically cannot enjoy the benefits of a treaty because all his foreign income is tax-exempt. Yet, if the person were fully exempt one would probably conclude that the Model applies anyway[431]. Finally, the structure of the rule requires a somewhat absurd reasoning: the person, while being treated as a resident domestically, needs to be treated for some reason (the origin of which is not clarified) after the application of the tie-breaker by the State which has lost the tie, as a tax-exempt person on all his foreign income.

As in the case of conduit companies, it is a known thing that dual residence conflicts can be created in order to achieve a tax efficient result, or perhaps more directly, to abuse tax treaties. Whether the second sentence of the definition of residence has the necessary means to prevent that outcome from the perspective of policy considerations is highly uncertain[432]. It does not seem reasonable that a simple change in the Commentaries would be capable of introducing a new anti-abuse approach[433] to a rule which was not meant to deal with cases of abuse in the first place. The OECD's approach is highly limited by the Model's incapacity to modify the laws of the contracting States, which appears to be the route the OECD intended to follow. Moreover, one cannot ignore the fact that, whilst these rules are so neatly seeking to impose standards on domestic residents to access the Model, the Commentaries nonetheless continue to state that this is not the case. All these inconsistencies naturally result in many difficulties when trying to apply the Model in a coherent manner. Lastly, this approach has another undesirable effect, which is the exclusion of residents of States applying a territorial system of taxation.

7.6. The exclusion of States applying a territorial system of taxation

7.6.1. Introduction

As was stated earlier, the need to clarify that States applying a territorial system of taxation were not excluded from the Model did not originate when residence was first discussed. On the

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428 As early as in 1975 the OECD stated: '*The same goal could be achieved by inserting in paragraph 1 of Article 4 after "For the purposes of this Convention" the words: "and the internal law of the Contracting States".*', CFA/WP1(75)5, at pp.2-3.

429 This is the case of France, see Delattre, supra note 125, at p.203; the United Kingdom, see FA 1994 Section 249(1); and Canada, see Income Tax Act, section 250(5).

430 The first reservation to Art.4 OECD MC was "Ireland cannot envisage treating as non-resident in Ireland an individual who is resident in that country under Irish law", DAF/FC/71.5, at p.2.

431 See infra, Chapter 8.

432 This question is explored in detail in Chapter 10.

433 Boccardo questions the ability of the new interpretation of the Commentaries to introduce an anti-abuse approach into treaties which are already in force, see Boccardo, supra note 427, at p.131.

contrary, it arose only when the OECD expanded the interpretation of the second sentence in Art.4 OECD MC to cases of conduit structures[434]. Under their current version, the Commentaries state:

> "The application of the second sentence, however, has inherent difficulties and limitations. *It has to be interpreted in light of its object and purpose, which is to exclude persons who are not subjected to the most comprehensive liability to tax generally imposed by a State*, because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended."[435]

The text in italics was added in 2008, after the exclusion of residents of a State losing a tie-breaker was made. According to the *new spirit* of the rule, its interpretation must be carried out in a manner in which a person who is exempt on all his foreign income (under international law) needs to be excluded from the application of the Model. This, however, needs to be done in a way in which its use by those who reside in a State applying a territorial system is not precluded. Several questions arise from this addition: Firstly, whether the different and allegedly contradictory statements in the Commentaries to the OECD may be reconciled through their interpretation; and secondly, and perhaps more importantly, what would be the effect of their inclusion for the purposes of the interpretation of the Model.

7.6.2. Defining States applying a territorial system of taxation

Lang defines a State applying a territorial system as one which extends its tax authority on the basis of the place from where the income originates, regardless of any personal connection between that State and the person who derived it[436]. Instead of a personal attachment, the determinative factor for taxation is the source of the income. This would allow the conclusion that territorial States "do not differentiate between limited and unlimited tax liability"[437], and therefore they could be defined as opposed to States applying the principle of worldwide taxation.

The Commentaries, however, seem to suggest that persons who are submitted to the tax authority of one of these States may nevertheless be called 'residents'[438], because they need not be excluded from the scope of the Model. This makes the distinction even more complex. Apparently, the difference between a State applying a territorial system versus a State following the worldwide principle would be focused only on the tax base. When extending its tax authority, a territorial State would simply not reach beyond its borders. A State following the worldwide principle, in turn, would.

The manner in which each system operates may give the impression that persons who are residents of a State applying the territorial principle are subject to 'limited' tax liability[439]. Such a conclusion, however, is not compatible with any attempt to include these States into the Model. It is nonetheless also possible that the sole purpose behind their inclusion was the possibility of restricting taxation at source through tax treaties. This may be a reasonable conclusion if one considers that the Model was drafted by developed countries, and they do not normally employ the territorial system of taxation. Assuming this was not the case, the need not to exclude these

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434 For an explanation of the reasons given see OECD, Report on base companies, supra note 280; and OECD, Report on conduit companies, supra note 280.

435 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).

436 These States extend their tax sovereignty "regardless of domicile, residence, place of management, or any other criterion of a similar nature", but only on account of the source of the income, see Lang, supra note 135, at p.597.

437 Lang, supra note 135, at p.597.

438 Sec.8.3 of Comm. to Art.4. OECD Model Convention (2014).

439 This would require the understanding that the territorial system operates on the basis of the income received and thus not on the basis of personal factors.

States would therefore require the assumption that the extension of their tax authority is based on personal factors, seen from a broad perspective[440]. After all, for the OECD MC to apply to these persons they need to overcome the residence test. The idea that a State applying a territorial system extends its tax authority by reason of a connecting attachment which is of a similar nature to those mentioned in Art.4 OECD MC is not strange in literature[441]. French authors have in fact explained that their corporate tax system is based on the allegiance between French companies and France[442]. The operation of the territorial principle in such cases is illustrated as no more than a mere restriction to the tax base of those companies[443], thereby justifying the use of tax treaties by French companies. If that were the case, these companies would fit into the profile of having a 'full' tax liability (namely a personal connection), restricted to income arising from sources in the respective State. The question would nevertheless still remain as to the possibility to not exclude these persons according to the second sentence in Art.4(1) OECD MC.

7.6.3. The need not to exclude territorial States under the OECD MC

Assuming that the tax liability of a person who is a resident of a State applying a territorial system is based on personal factors, there is one more obstacle to overcome. The second sentence is meant to exclude from the Model certain persons who, despite being residents of a State, are nevertheless taxed only on income from sources therein. If the rule is read to the letter, in truth there is little to argue against the exclusion. Residents of States applying a territorial system of taxation are taxed only on income from sources in those States, and all their foreign income is tax-exempt. Any attempt to reconcile the diverging and seemingly inconsistent rules in the Commentaries, however, requires a much deeper look.

When the reasons behind the new interpretation of the second sentence introduced in 1992 were explored, it was relatively clear that, having the conduit issue in mind, the OECD sought to introduce a general anti-abuse principle. Based on this principle, if a company was set up with the sole purpose of accessing treaty benefits, then such a company could not be treated as a resident for treaty purposes. The presence of abuse, however, was given by the artificial creation of a person in order to access the treaty and not by the double non-taxation generated at the core of it. Despite how questionable the compatibility of this interpretation may be with the original scope of the rule interpreted, it is somewhat clear that this new manner of reading Art.4 OECD MC followed such purpose. The addition of the dual residence issue in 2008 had a similar connotation.

It may be argued that the relevant factor to justify the exclusion of conduit structures and dual residents from the Model was the potential for tax avoidance. In that context, the fact that the OECD stated the need to not exclude residents of States applying a territorial system should not be striking. If the provisions of the second sentence are read broadly, they leave enough space to conclude that any person whose entire foreign income is tax-exempt should be excluded from the

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440 See supra, Chapter 5, at pp.60ff.

441 To Lang, "There is much to be said in favour of not determining the similarity described in Art4(1) based on which other criterion also results in unlimited tax liability, but to determine access to treaty benefits based on which other criteria imply a similarly close connection to the state", Lang, supra note 135, at p.598.

442 Gest, supra note 286, at p.188. Regardless of the fact that courts do not normally refer to the concept of residence in tax treaties, this has been the formula applied by France in relation to corporations which are subject to a territorial system of taxation, see de Boynes, supra note 172, at pp.446-450 and at pp.454-455. This position would be supported by the consideration of 'source' between the criteria of entitlement in the history of the Model: "Such Conventions apportion between the two contracting States in accordance with certain criteria (known as criteria of attachment, such as domicile, location, place of employment, *source*), the right to tax [...]", see FC/WP2(57)2, at p.5. The idea, however, is not easily accepted by everyone, see Lehérissel, supra note 192, at p.159.

443 And thus their tax liability would be based on personal factors and not solely in the income derived by the person, see FC/WP2(56)1, at p.1.

application of the Model. On the contrary, if the guidelines given by the OECD are followed and the rule is read restrictively, the situation changes. The anti-abuse principle embedded into the rule implies the need to exclude from the application of the Model only those persons who have attempted to use it as part of a tax avoidance scheme. In that case, it may easily be concluded that residents of a State applying a territorial system are not exempt on all their foreign income by reason of a tax avoidance strategy. Therefore, even if they are in fact taxed only on income from sources in a given State, they ought not to be excluded from the application of the Model.

While the approach followed by the OECD in order to confront treaty abuse by interpreting Art.4 OECD MC generates many apprehensions, this is the only reasonable manner to reconcile the rules of the Commentaries. Yet, the effects of making the effort to try not to exclude these States from the scope of the Model clarifies a series of fundamental aspects of it: Firstly, that the purpose of tax treaties is not restricted to the avoidance of double taxation. Inasmuch as a territorial State would only tax income from sources therein, there would be no true risk of double taxation in relation to its residents. Secondly, that the Model does not aim at preventing double non-taxation. If a territorial State acts as the State of residence, the relevant person will not be taxed on income other than that arising from sources in that State. Such a person would nonetheless be able to claim the reduced rates of withholding tax at source by applying the treaty, eventually causing non-taxation. On the contrary, if the territorial State acts as the State of source and the benefits of the Model are claimed by a tax-exempt resident of another State, the limit imposed by the treaty would probably operate[444]. Thirdly, that double non-taxation cannot be easily taken for tax avoidance. A person may be exempt on all his foreign income, thus generating non-taxation, and yet the provision needs to be read restrictively. If there were no tax avoidance, as in the case of a resident of a territorial State, the exclusion from the Model would not be justified by the *new spirit* of the rule.

7.7. Evaluation: 'Liable to tax' and the second sentence of Art.4 OECD MC

The existence of the terms 'full', 'unlimited' and 'comprehensive' tax liability has traditionally been presented as an effect of the second sentence in Art.4(1) OECD MC. As has been explained before, this is not correct. These terms described tax liability for the purposes of the definition of residence more than a decade prior to the addition of the second sentence in a very straightforward manner: there was either a 'full', 'comprehensive' and 'unlimited' tax liability, meaning a personal connection with a State justifying residence, or a 'limited' one, focused on the income, and for the purposes of which the personal attachment was immaterial.

From the confusing literature and case law on the matter, the analysis of the situation of diplomats seems to have changed the meaning of the expressions 'full' and 'limited', in a way of introducing several shades of the term 'liable to tax'. It is very clear that this was not the case. The new rule, included in 1963 to the Commentaries and in 1976 to the definition of residence in the Model, was the last link of a complex chain of provisions aimed at preventing a very precise outcome: the fact that a diplomat may have been able to obtain diplomatic benefits under international law and, at the same time, tax treaty benefits. The situation of a diplomat in such a case did not give place to 'limited' tax liability, as most literature explains, but only to a 'full' tax liability restricted to certain items of income. While the distinction may seem to be irrelevant, several difficulties in applying tax treaties derive from these confusing terms. One needs to bear in mind that the tax liability described in the second sentence of Art.4 OECD MC requires the

444 This question is explored in the following Chapter.

presence of residence at the domestic level (full tax liability), and therefore it cannot be labelled as 'limited' or 'impersonal'.

The core of the issue of diplomats was one tax treaty entitlement in circumstances that appeared to be unintended. This explains the attitude of the OECD towards the rule at a later stage. The additions to the Commentaries in 1992 and 2008 were aimed at confronting specific scenarios of perceived tax treaty abuse, and yet when the scope of the original rule is examined, it is fairly clear that there was no abuse in the situation of a diplomat. A diplomat did not set up residence in order to provoke a certain tax result, while this was at the heart of the questions raised by the conduit and the dual residence issues. History, in fact, is quite clear in demonstrating that the OECD never mixed up these concerns. The situation of diplomats, on the one hand, and that of conduit structures and dual residents on the other hand were not only debated contemporarily, but they were analysed for years by the same working group within the OECD, and even in identical meetings. These issues were nonetheless discussed separately, as they were in essence dissimilar. Hence, when the OECD so firmly states, after thirty years in the case of conduits and forty-four years in the case of dual residents, that the spirit of the rule is *also* to materialise those exclusions, one cannot but wonder whether there is a missing piece in the OECD's reasoning. That element is, in simple terms, that the original rule was not meant to contend with scenarios of abuse, namely, with the artificial creation of the conditions required to establishing residence and therefore accessing tax treaties[445].

The necessity to contend with tax treaty abuse is a very justified one. However, the broadest question of whether the definition of residence has the appropriate policy means to deal with the issue of treaty abuse (explored in subsequent parts of this study[446]) is a different question. It does not seem that forcing an anti-avoidance *spirit* through the interpretation of a rule in the Commentaries may be the most efficient way deal with the issue, especially if the rule interpreted was not designed to address such concerns in the first place. As a matter of fact, the path the OECD has decided to follow has created the need to clarify that residents of States applying a territorial system of taxation are not excluded from the application of the Model. When the question is raised as to why this clarification was not required before 1992, the answer is simple. The fact that a resident of one of those States was tax-exempt on all his foreign income did not necessarily derive from a strategy of tax avoidance. One may agree with the OECD in relation to the need to interpret the Commentaries to the Model *dynamically* and not *statically*, so as to keep the meaning of tax treaty terms up-to-date. This, however, cannot imply that a simple modification to the Commentaries may have the authority to change the meaning of a treaty term, which was the case in 1992, and later on in 2008.

After the new interpretation of Art.4 OECD MC was inserted in the Commentaries, any person who is a resident according to the domestic laws of a State, but it is nonetheless taxed only on income from sources in that State, may be excluded from the application of the Model. However, the need to interpret the rule *restrictively* (according to the guidelines provided by the OECD) implies that a person whose entire foreign income is tax-exempt may only be excluded from the scope of the Model if the exemption results from a scheme of tax avoidance. This would seem to suggest, at the same time, that unless a clear avoidance motivation may be observed and proved, the setting up of

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445 Vann, in fact, has concluded that the interpretation of the Model promoted in 2008 misreads the second sentence and departs from its historical origin, see Vann, supra note 41, at pp.253-254.

446 This question will be explored in detail in Chapters 10 and 11 of this work.

a conduit company or the fact that a person loses a tie-breaker cannot necessarily mean that such a person needs to be excluded from the Model[447].

The fundamental problem the new interpretation of the rule entails is that it assumes the existence of abuse in some cases, without giving a hint of what abuse really is in the context of the Model itself. Under the definition of residence, however, there is no clear answer to the question of abuse. What abusive treaty entitlement is seems to depend on the agreement of the parties, and therefore whether the creation of a conduit company implies abuse is not the real question one needs to explore. That conviction must be reached on the basis of the analysis of the Model. Needless to say, the chances of persuading any reasonable interpreter to prevent a conduit structure from accessing treaty benefits decrease significantly if it is accepted that the Model does not lay down standards which domestic residents need to fulfil to access tax treaties. If that were true, the conditions to measure the appropriateness of such a claim would lie on the domestic laws of the relevant States exclusively.

Finally, it is fundamental to emphasise the consequences of having clarified that residents of a State applying a territorial system need not be excluded from the application of the Model for the purposes of its interpretation. In the first place, the fact that one of these residents may be able to claim the benefits of the OECD MC cannot but imply that residence is not a synonym of worldwide tax liability. Secondly, this implies that the Model is not really aimed at the avoidance of double taxation, otherwise treaty benefits in the State of source would not be needed. Tax treaties, in those cases, aim more generically at allocating tax jurisdiction. Likewise, the parallel recognition of treaty benefits to one of these persons in the State of source implies that double non-taxation is not necessarily without the scope of the Model. After all, a territorial State does not need to exercise its tax authority in order to make the restriction at source applicable and, even if this were the case, its extension would not affect income arising beyond its borders. Lastly, it suggests that double non-taxation cannot be equated to tax avoidance. Even if a person is exempt on all his foreign income as they normally are in these States, the benefits of the Model cannot be neglected in the presence of non-taxation, if the avoidance scheme is not proved.

[447] In the same lines, "it is noted that dual residence is a result of conflicting residency rules of two legislations and is not necessarily related to tax avoidance", see Gyöngyi Végh, Perla, 'OECD: Facing the Challenges of Electronic Commerce (Direct Taxation)', in 41 *European Taxation* 4 (2001), at p.162.

8. Chapter 8
'Liable to tax', 'subject to tax' and 'taxed': Tax liability and effective taxation

8.1. Introduction: Tax liability and effective taxation

One of the most relevant discussions raised in the context of Art.4 OECD MC is whether effective taxation is a condition for tax liability to arise, and therefore whether the exercise of a State's tax authority over the treaty claimant operates as a requirement for treaty benefits to be granted. This question is seemingly relevant in the case of tax-exempt pension funds, charities and educational institutions, amongst other persons that are usually not subject to the obligation to pay taxes. The absence of taxation may create a problem in the State of source, where the reduced rates of withholding tax may be denied, and also in the State of residence, where treaty benefits may not be granted if the income is not taxed at source.

Access to tax treaties in the case of tax-exempt pension funds, charities or educational institutions is not something the courts would easily agree upon. More often than not, treaties are interpreted in a way in which those benefits are denied. Such an interpretation is based on the need to apply tax treaties according to their alleged primary purpose, namely the avoidance of double taxation, but reasons are rarely given from the perspective of its text.

It is nonetheless evident that the text of the OECD MC cannot be ignored when confronting this issue, because "the relevant question is not so much what a treaty was intended to say, but rather what it actually says"[448]. It is the words of the Model that need to be analysed when trying to answer questions such as "should tax liability in the source country depend on how the income in question is taxed in the residence country?"[449], or to support statements like "benefits should only be granted to the extent that they eliminate double taxation or double non-taxation"[450]. While the OECD has tried to approach the issue of non-taxation from the perspective of the manner in which the Model *should* operate, it repeatedly overlooks both the history of the relevant provisions and their text. The analysis of whether effective taxation is in fact required under the rules of the OECD MC to access treaty benefits needs to be explored, first of all, from the perspective of the Model itself.

8.2. 'Liable to tax', 'subject to tax' and 'taxed'

There are different terms that have been used during the discussions on tax treaty entitlement. The terms 'liable to tax', 'subject to tax' and 'taxed' represent different dimensions of the same phenomenon: the need of effective payment of taxes in order to avail the benefits of the Model. While the OEEC, at the beginning of its work, used the terms 'liable' and 'subject' to tax interchangeably[451], it is nonetheless evident that at a certain point it started restricting the use of the term 'subject to tax' to situations in which the effective payment of taxes was required[452]. The use of these expressions, however, is determined also by other factors, like language. While in the English version of the Model a clear distinction can be drawn between the terms 'liable' and 'subject' to tax[453], the French[454], the Spanish[455], the Portuguese[456] and the Italian[457] versions, for

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[448] Engelen, Frank, *Interpretation of Tax Treaties under International Law*, (Amsterdam: IBFD, 2004), at p.427.
[449] Easson, supra note 93, at p.624.
[450] Galea, supra note 208, section 3.2.2.2.
[451] FC/WP2(57)3, at p.6, using 'subject to tax' to refer to 'liable to tax'.
[452] FC/WP14(60)1, at p.3.
[453] Despite the instances during the history of the OECD in which both terms were used indistinctively.
[454] 'Assujettie a impôts'. Perhaps as an effect of this, some authors do not make any distinction between 'subject' and 'liable' to tax, see Schaffner, supra note 173, at p.219.

instance, use a term the translation of which is literally closer to 'subject to tax', but it nevertheless refers to the English version of 'liable to tax'[458]. Accordingly, for the purposes of this section, 'liable to tax' will be referred to as opposed to 'subject to tax' which, regardless of the precision made in relation to States using certain languages, refers, more precisely, to the term 'taxed'[459].

8.3. Tax liability and effective taxation in the State of source

8.3.1. Introduction: An historical perspective

The first step in the application of a tax treaty is the claim being raised in the State of source to apply the reduced rate of withholding tax or to refrain from taxing, depending on the provision invoked. Whether the recognition of these benefits depends on the event of effective taxation in the State of residence was a question actually discussed through the history of the Model. According to the records of the Fiscal Committee:

> 'The Delegate for Switzerland, acting as Rapporteur, said that the question was whether the country of source was bound to apply the reduced rate provided in the Convention where the taxpayer was not taxed in the country of residence by reason of losses or reliefs or because the country of residence did not tax income derived from abroad. *He thought that the "subject to tax" clause was necessary to prevent non-taxation.* The Delegate for the United Kingdom thought [...] that the Commentary should allow the countries concerned to apply *such limitation* by bilateral negotiations. The Delegate for Italy shared this view. The Delegate for the Netherlands thought that the country of source should not make the reduction of its tax conditional upon the taxpayer being taxed by the country of residence. Certain countries, for instance, did not tax dividends received by a company from its subsidiary. Nevertheless, he agreed to the question being mentioned in the Commentaries.'[460]

The character of the observations made suggests that a subject to tax approach from the perspective of the State of source was taken, at best, as an alternative provision to be included in the Commentaries. The inconvenience of that approach being adopted in the Model itself was something in which the different Working Parties of the OECD converged. By way of illustration, in relation to the rules of taxation of dividends, Working Party 12, after clarifying that tax liability in the State of residence was not subject to the event of effective taxation, explained:

> "The State of source should also give relief from its tax when, owing to losses or social security deductions or to the receipt of income exempt from tax, etc., the taxpayer pays no tax. The evidence of liability in the other State *is not therefore in the nature of a clause designed to prevent effective double taxation alone*."[461]

Although it was never mentioned explicitly, the ultimate reason why the presence of such a clause was rejected seems to derive from the manner in which the rule of residence was built. In principle, all that the OECD MC requires for the restriction over the State of source to operate is a person who is subject to the tax authority of the other contracting State as a resident. As was stated before, this is at the essence of the ordinary meaning of the term 'liable to tax'[462]. If the

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455 'Sujeta a imposición'.
456 'Sujeita a imposto'.
457 'Assoggettata ad imposta'.
458 The proof of this lies in the fact that the official English version of the treaties entered into by the States using those languages, in the definition of residence, refers to 'liable to tax'.
459 India, Authority for Advanced Rulings of Delhi, 14 December 2005, *General Electric Pension Trust*, at para.9. See also de Broe, Luc, 'Interpretation of Subject-to-Tax Clauses in Belgium's Tax Treaties – Critical Analysis of the "*Exemption vaut Impôt"* Doctrine', in 63 *Bulletin for International Taxation* 2 (2009).
460 Emphasis added. FC/M(60)3, at pp.10-11.
461 Emphasis added. FC/WP12(58)1, at p.15.
462 See supra, Chapter 6.

State of source considers that effective taxation ought to be included as a condition to apply the rules of the treaty, it must guide the negotiation towards that objective. If it does not do so, there is no space for subsequent quarrels. In fact, every time a treaty is concluded:

> "[…] each of the states must be presumed to have made a mutual examination of the concept of domicile of the other state and found it satisfactory; for the rest a state will always have a possibility of terminating its tax renunciation by denunciation of the agreement."[463]

It was certainly the opinion of the drafters of the OECD MC that the presence of a subject to tax clause from the perspective of the State of source was neither implied nor convenient, and on the basis of this conviction the drafting of the Model was carried out.

8.3.2. A subject to tax approach in the State of source

Following the agreement of the Fiscal Committee, there is no mention in the Model to the necessity of effective taxation in the State of residence in order to make the restriction imposed by the Model applicable to the State of source. Accordingly, few States use this approach, and when they do it, it is used only in limited tax treaties[464]. States do, however, have the option to alter the natural effect of the OECD MC so as to avoid double non-taxation[465] in a way described in the Commentaries:

> "General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention *does not recommend such a general provision*."[466]

While it would be quite interesting to know the many reasons that drove the OECD to discourage the use of these clauses, they have not been expressed. It is very likely that they refer, in the first place, to the need of stability. If the benefits of a treaty in the State of source were made dependent upon taxation in the State of residence, an obvious temporal difficulty would arise. The State of residence normally imposes taxation after the particular situation in the State of source has been settled. If the State of residence decides to exempt the relevant income after the State of source has recognised the benefits of the treaty, the need would arise to reverse the situation. The reasons may also refer to the means of communication available at the time tax treaties were first discussed, an observation that is however less pertinent nowadays, given the rise of new technology.

Regardless of these formal aspects, if one looks closely, these reasons may primarily refer to the need to structure a treaty model on the basis of domestic rules. The essence of the subject to tax approach makes the recognition of treaty benefits conditional upon taxation of the *relevant income* in the State of residence[467]. As was stated earlier, the situation of the income for which treaty benefits are claimed is not relevant for the purposes of the ordinary meaning of the term

[463] FC/WP2(56)1, at p.7.

[464] It has been taken to be exceptional in Austria, where "in only a few treaties does the limitation on the source state's taxing rights depend on taxation in the residence state", see Achatz, Markus, et al., 'Taxation of Non-Resident Individuals in Austria', in 58 *Bulletin for International Taxation* 11 (2004), at p.529. For an illustration of subject to tax clauses which establish taxation in the State of residence for restricting the taxing rights of the State of source see Burgstaller, Eva, Schilcher, Michael, 'Subject-to-Tax Clauses in Tax Treaties', 44 *European Taxation* 6 (2004), at pp.271-273.

[465] Subject to tax clauses seek to avoid double non-taxation, see Burgstaller, supra note 464, at p.266.

[466] Emphasis added. Sec.15 of Comm. to Art.1 OECD Model Convention (2014).

[467] Sec.15 of Comm. to Art.1 OECD Model Convention (2014).

'liable to tax'. In other words, a subject to tax clause would switch the subjective approach on treaty entitlement for an objective one, focused on the income. This, however, would restrict the possibility of sustaining that any domestic resident is 'liable to tax' in terms of generating residence for treaty purposes, a result that the OECD clearly does not intend.

In any case, it is clear that the OECD does not recommend the use of these clauses from a general perspective[468]. Different States, however, in order to prevent scenarios of non-taxation, have disregarded this recommendation. The problem this entails is that every time this rule is used it must be adapted to the particular conditions of the treaty under negotiation, and thus the precise form of each rule depends on the treaty in which it is included. While the use of different rules imposes a series of interpretative obstacles[469], the States are willing to face those difficulties in order to restrict the operation of their treaties to cases of effective double taxation.

Regardless of the apparent straightforwardness of the subject to tax approach, there are still difficulties in order to determine the precise circumstances in which the income should be considered to be 'taxed' in the State of residence. Even in States using a subject to tax clause in their treaties, courts have been willing to recognise the benefits of those treaties in cases of non-taxation, when the circumstances seem to be justified[470]. These States have been forced not to rely in these clauses, but to introduce more fundamental changes to their domestic laws in order to prevent double non-taxation[471]. The effectiveness of the approach in securing the application of treaties only to cases of effective double taxation is, therefore, quite doubtful[472].

8.4. Tax liability, effective taxation and relief in the State of residence

8.4.1. Effective taxation as a condition for tax treaty entitlement

The need of effective taxation for the purposes of tax treaty entitlement has also been discussed from the combined perspective of both contracting States. A rule was in fact proposed by Working Party 2 to accompany the proposed definition of residence for treaty purposes:

> "Where the right to tax has been conferred on a Member country by this agreement but is not exercised by that country, this Agreement shall not prevent taxation in another Member country."[473]

Further, the scope of the rule was explained:

> "The Working Party would finally state that in Article III, para.2, it has been proposed that the Agreement shall not prevent taxation being levied even if the right to tax has been given up under the agreement, if the country to which the right to tax has been conceded does not exercise that right. It seems reasonable for the countries

468 Although to some "[i]t should be possible to have a treaty provision to safeguard the payer's residence state from giving up taxing rights to a state which does not exercise its right to tax […]", see Avery Jones et al., 'Treaty Problems Relating to Source', in 38 *European Taxation* 3 (1998), at p.93.

469 Each clause must be interpreted differently, see Burgstaller, supra note 464, at p.276.

470 If non-taxation is justified by reason of domestic policy, Lampe, Marc, 'General Subject-To-Tax Clauses in Recent Tax Treaties', in 39 *European Taxation* 4 (1999), at p.188. See also Resch, Richard, 'The New German Unilateral Switch-Over and Subject-to-Tax Rule', in 47 *European Taxation* 10 (2007), at pp.480-483.

471 Resch, supra note 470, at pp.480-483.

472 Inasmuch as it necessarily interferes "with the generally accepted principle that the state of residence must exempt income whether or not the right to tax is in effect exercised by the other state", see the comments in relation to the German position in Lüdicke, Jürgen, 'Exemption and Tax Credit in German Tax Treaties – Policy and Reality', in Baker, Ph., et al., (eds.), *Tax Polymath*, (Amsterdam: IBFD, 2010), at pp.292-293.

473 FC/WP2(57)1, at p.3.

to be given an express option of making the application of the rules of the Agreement conditional upon a claim for tax having actually been raised by several quarters against the same taxpayer."[474]

The possibility to include such a rule in the text of the Model, however, was rejected:

"The rule proposed by the Working Party aims only at the apportionment of the right to tax which is attached to residence, but it can never result in a residence State acquiring the right to tax an income which, as the residence State, it has renounced its right to tax."[475]

As was stated earlier, the possibility to include a rule that requires effective taxation as a condition for treaty benefits was no more than an alternative given to the States wanting to deviate from the normal operation of the Model. By recognising their ability to use this provision, the drafters of the OECD MC acknowledged that such an effect could not be attributed to its text as it stood. The Model was meant to avoid double taxation. However, if effective double taxation was not part of the picture at the time treaty benefits were claimed (for instance because one of the States did not exercise its right to tax), the need to apply the treaty subsisted under the form of an agreement for the allocation of tax jurisdiction. The parties had to expressly modify the text of the Model in order to alter this configuration.

This conviction was not strange to other working groups within the OECD. In the field of dividends, Working Party 12 declared:

"The proof of liability to taxation in his State of residence is only to the effect that the viewpoint of the dividends is liable in principle to tax on them; it does not imply that a tax has actually been paid to them."[476]

Moreover, during the discussion of the current Art.21 OECD MC, which attributes to the State of residence the right to tax all items of income not expressly dealt with in other articles of the Model[477], Working Party 14 stated:

"The application of Article B [current Art.21] is not limited to income which is subject to tax in the State of which the recipient is a resident. It may be, however, that certain Contracting States may whish when entering into bilateral Conventions to limit the scope of the Article to such income."[478]

The current Commentaries to Art.21 OECD MC recognise this and in fact add:

"The rule set out in the paragraph applies irrespective of whether the right to tax is in fact exercised by the State of residence, and thus, when the income arises in the other Contracting State, *that State cannot impose tax even if the income is not taxed in the first-mentioned State*. [...]

In order to avoid non-taxation, Contracting States may agree to limit the scope of the Article to income which is taxed in the Contracting State of which the recipient is a resident and may modify the provisions of the paragraph accordingly. In fact, this problem is merely a special aspect of the general problem dealt with in paragraphs 34 and 35 of the Commentary on Article 23A."[479]

The general problem to which sections 34 and 35 of the Commentaries to Art.23A OECD MC refer is the need to recognise an exemption regardless of the situation of the income in the State of residence, examined in the subsequent paragraphs. Hence, not only the history of the Model but

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474 Emphasis in original. FC/WP2(57)1, at p.9.
475 FC/WP2(57)2, at p.2.
476 FC/WP12(58)1, at p.15.
477 Art.21 OECD Model Convention (2014).
478 FC/WP14(60)1, at p.3. Under this formula the Commentary to the Article was drafted, see FC(60)1, at p.19, and finally approved by the Fiscal Committee, see TFD/FC/89, at p.2, and FC(60)2, at p.36.
479 Emphasis added. Sec.3 of Comm. to Art.21 OECD Model Convention (2014).

also the current drafting which resulted from this history suggests that the ordinary meaning on the term 'liable to tax' does not require effective taxation for the purposes of treaty entitlement. Some States have included subject to tax rules in their treaties in order to alter this effect[480], which seems to strengthen the conclusion that taxation is not a condition for the Model to apply.

This discussion nonetheless lacks a fundamental point, which is the consideration of the so-called methods of relief used by each State. It was in the context of this debate that Working Party 12, on the taxation of dividends, proposed the creation of a new working group to deal with this issue in particular[481]. By studying the methods of relief, Working Party 15[482] completed the analysis of whether effective taxation was in fact a condition for the Model to apply. Its main contribution lies in the explanations given in relation to the policy objectives followed by the OECD in the elaboration of its model convention, and the impact of this policy in its text.

8.4.2. Art.23 OECD MC and income that 'may be taxed'

According to its current wording, Art.23 OECD MC states:

> "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, *may be taxed* in the other Contracting State, the first-mentioned State shall [...]"[483].

The use of the expression 'may be taxed' in this article was subject to extensive consideration by Working Party 15. While the selection of this precise terminology was somewhat accidental[484], the meaning behind it was not a coincidence, but it accurately materialised the policy objective behind the exemption system:

> 'The use of the term "may be taxed" implies that the State of residence shall give exemption irrespective of the fact whether the State of source makes use of the right to tax which it has under the Convention, or not. If the renunciation of taxation of the State of residence is made dependent on an actual taxation in the State of source the term "may be taxed" must be replaced by the term "is subject to tax".'[485]

This observation was submitted to the Fiscal Committee for its analysis. While examining the use of the term 'may be taxed' in the context of the rule of exemption, the opinion of the Fiscal Committee as to the policy objective behind the expression seemed unanimous:

> 'In connection with the first question, the Delegate for Denmark, Rapporteur of Working Party No.14, pointed out that most Conventions based on the exemption system lay down that the country of residence shall allow full exemption, whether the income is subject to tax in the country of source or not. The question of limiting exemption to income which is subject to tax only arises if it is desired that there should be a balance between the results produced by the exemption system and by the credit system, since the latter only makes allowance for income which is actually taxed. This limitation would, however, create certain administrative complications, since the taxpayer would have to provide evidence of the tax paid in the country of source. The Delegate for Luxembourg suggested that the expression "is subject to tax" should be used in Article C [current Art.23 OECD MC] in order to re-establish the balance between two countries using different systems. The

480 The treaty between Belgium and Egypt uses the expression 'subject to tax' instead of 'liable to tax', to require effective taxation for tax treaty entitlement, see Bellens, supra note 238, at p.292.
481 "This question must be examined by a new Working Party appointed to study methods of avoiding double taxation", see FC/WP12(58)1, at p.16. Before that, each State was bound to apply the method of relief contained in its domestic laws, see TFD/FC/68, at p.1.
482 Appointed at the 10th session of the Fiscal Committee in November 1958, see FC/WP15(59)1, at p.1.
483 Emphasis added. The rules in Art.23A and Art.23B OECD Model Convention (2014) share a common structure. As a matter of fact, in the original version, both articles were included in the same rule, see FC/WP15(60)2, at p.2.
484 The precise term used to express this idea could have been other, see C(59)147, at p.14.
485 FC/WP15(59)2, at p.5.

> Delegate for the Netherlands expressed the opinion that the limitation of exemption to incomes actually taxed would constitute a retrograde step, since the Convention ought not to be restricted to the avoidance of actual double taxation, but should on the contrary settle the attribution of the right to tax between States. Any such limitation might deprive the country of source of the result it seeks to achieve by not taxing certain kinds of income. The Delegate for Switzerland thought that exemption ought to be allowed in all cases, as a serious element of doubt would be created if a State's right to tax were made dependent upon actual taxation in the other State. This view was shared by the Delegate for Austria.'[486]

The fact that a Delegate suggested to use the term 'subject to tax' instead of 'may be tax' to re-establish the balance between the credit and the exemption system demonstrates that they all agreed in the sense given to the latter expression. The Fiscal Committee and Working Party 15 were well aware of the fact that the use of the term 'may be taxed' carried on the need to assume certain consequences. Accordingly, Working Party 15 closed the debate by stating that:

> 'The use of the term "may be taxed" effects that the State of residence shall give exemption irrespective of whether the State of source makes use of the right to tax which it has under the Convention, or not. At its 16th Session the Fiscal Committee again discussed this question and decided in favour of the expression "may be taxed" with the consequent effect of exemption in the State of residence.'[487]

8.4.3. Exemption method: The *absolute obligation* to provide exemption

In its final report in relation to the methods of relief, Working Party 15 explained, under the title 'the obligation of the State of residence to give exemption', that:

> '32. In the Article it is laid down that the State of residence shall exempt from tax income and capital, which in accordance with the Convention "may be taxed" in the other State. The State of residence must accordingly give exemption whether or not the income or capital in question is actually taxed in the State of source. This is in accordance with most Conventions based on the exemption system between Member States of OEEC. It is regarded as the most practical method since it relieves the State of residence from undertaking onerous and time-consuming investigations of the actual taxation position in the State of source.
>
> 33. Exceptionally some negotiating States may find it reasonable in certain circumstances to deviate from the provision concerning *the absolute obligation of the State of residence to give exemption*."[488]

This occurred regardless of an observation made by the Delegate for Switzerland:

> 'He though that the "subject to tax" clause was necessary to prevent non-taxation.'[489]

The Delegates, however, agreed only on the possibility of including such an observation in the Commentaries, to provide the States with an alternative to what they though to be the obvious effect of the rule of exemption[490]. As a matter of fact, the Commentaries were drafted to explicitly recognise that:

> "To avoid non-taxation of specific items of income, Contracting States may agree to *amend* the relevant Article itself"[491].

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486 FC/M(60)1, at p.9.
487 FC/WP15(60)1, at p.8.
488 Emphasis added. FC/WP15(60)2, at p.14; the same in TDF/FC/126, at pp.53-54.
489 FC/M(60)3, at p.10.
490 And so it appeared in the approved version of the Commentaries, see FC/WP15(60)2, at p.14; and as such it remains in the Commentaries today, as an option, see Sec.35 of Comm. to Art.23 OECD Model Convention (2014).
491 Emphasis added. CFA/WP1(75)5, at p.20; and CFA/WP1(76)4, at p.12. An observation that in essence remains the same in Sec.35 of Comm. to Article 23 OECD Model Convention (2014).

The agreement in relation to the logic behind the exemption system was so strongly settled that certain answers were given which today would seem outrageous. The question of exemption in the case of tax evasion in the State of source, for instance, was raised as early as in 1974:

> "19. The German Delegation raised the question whether exemption has to be granted even in cases of tax evasion where the income in question has not been taxed in the State of source. (Consolidated List of Outstanding Points of 21st July, 1967).
>
> 20. It is the opinion of the Working Group that exemption from tax in one Contracting State (R) is not to be made dependent upon the income being subject to tax in the other Contracting State (P) or (S). This is expressed clearly in paragraphs 32 and 48, of the Commentary on Article 23A with respect to the exemption to be granted by State (R)."[492]

While one may tend to think that the OECD would have corrected this interpretation of the Model, it is somewhat striking to realise that they still find support in the very text of the current Commentaries. The absolute obligation to provide exemption subsists today in the following terms:

> "34. The State of residence must accordingly exempt income and capital which may be taxed by the other State in accordance with the Convention, whether or not the right to tax is in effect exercised in the other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State. [...]
>
> 35. Occasionally, negotiating States may find it reasonable in certain circumstances, *in order to avoid double non-taxation*, *to make an exception to the absolute obligation on the State of residence to give exemption* in cases where neither paragraph 3 or 4 would apply. Such may be the case where no tax on specific items of income or capital is provided under the domestic law of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid such double non-taxation of specific items of income, Contracting States may agree to *amend* the relevant Article [...]"[493].

One cannot ignore the essential similarity with the original explanations given by Working Party 15 quoted above, more than half a century ago, in order to justify the presence of non-taxation due to the application of the exemption method. Irrespective of the fact that the word 'exceptionally' has been replaced by the term 'occasionally', and that certain exceptions have been added to the text of the current Commentaries[494], the heart of the principle remains the same: effective taxation is simply immaterial for the Model to apply. Under these conditions it would be fruitless to contend that the presence of taxation may be of importance when attributing its ordinary meaning to the term 'liable to tax'.

Some random statements by the OECD in order to denounce the use of its model convention in scenarios of double non-taxation, as in the sphere of the BEPS project, have not been able to prevent its use in this context. The situation however should not be striking. Not only with enough reason but also with plain theoretical support, provided no less than by the OECD, treaty benefits have successfully been claimed in cases of absolute non-taxation[495]. Even if it seems irrational, every time a court makes a case for arguing something as fair and reasonable as effective taxation

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[492] CFA/WP1(74)2(1974), at p.6.

[493] Emphasis added. Sec.35 of Comm. to Art.23 OECD Model Convention (2014).

[494] Sec.34.1 of Comm. to Art.23 OECD Model Convention (2014), explored in the following section.

[495] The obligation to provide exemption cannot be avoided: The Netherlands, Supreme Court, 21 December 1994, *Case 28.953*, BNB 1995/143c; The Netherlands, Supreme Court, 4 December 2009, *Case 08/05071*, V-N 2009/62.5. Vogel has commented a decision of the Court of Appeal of Amsterdam, which refused the allegation of the tax authorities that "factual subjective indebtedness" instead of simple tax liability was required for the purposes of tax treaties, see Vogel, Klaus, 'Tax Treaty News', in 60 *Bulletin for International Taxation* 6 (2006), at pp.218-219.

in at least one of the States in order to grant the benefits of a tax treaty, it must struggle with the interpretation sustained by the OECD of its Model. While some authors and even the OECD in present times have argued that tax treaties must have been built under the assumption that at least one of the States was supposed to tax the relevant income[496], this is evidently ineffective. Double non-taxation is a phenomenon which has been getting much attention under the current economic scenario. However, one cannot simply blame the courts for allowing multinational companies not to pay taxes. A closer look must be taken to the principles over which tax treaties have been built, otherwise this will result in a never-ending discussion.

8.4.4. Double non-taxation in conflicts of characterisation: An exception

Conflicts of characterisation[497] relate to the situation of transparent entities. They have been explained by the OECD in relation to partnerships, but it is relatively accepted that the principles lied down in the Partnership Report[498] are generally applicable to situations of transparency[499]. This is in fact an idea that the OECD has intended to promote through its latest work on BEPS[500]. The report is based on the disagreement of the States applying a treaty as to the person to whom the relevant income must be attributed. While one of the contracting States sees an entity, the other State does not. As a consequence of this, the income for which treaty benefits are claimed is attributed by each State to different persons.

In those cases, under the rules of the report, duly recognised in the Commentaries to the Model[501], the State of source is obliged to follow the characterisation of the entity made by the State of residence[502]. For instance, if the State of residence sees an entity and therefore attributes the income to that entity, the State of source has to apply the treaty considering that. This would occur even if the State of source sees the entity as transparent and it attributes the income to its members (in such a case the State of source must ignore its own rules, attribute the income to the entity itself and apply the treaty accordingly). Conversely, if the State of residence does not see an entity and it attributes the income to its members, it is in respect of these persons that the State of source must analyse the treaty, even if it disagrees as to the transparent character of the entity.

In that context, it may occur that the State of source, regardless of the fact that under its domestic law considers that it has the right to tax the income, applies the provisions of the convention, that is, it follows the characterisation made by the State of residence, only to conclude that it must

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496 According to what the OECD has stated in the field of BEPS: "[...] some rules and their underlying policy were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere", see OECD, Addressing BEPS, supra note 27, at p.47. This traditional view of treaties has been shared by van Weeghel, supra note 133, at p.33 and at p.105; and de Broe, Luc, *International Tax Planning and Prevention of Abuse*, (Amsterdam: IBFD, 2008), at p.357.

497 The OECD has referred to these conflicts as conflicts of 'qualification', while in reality these are conflicts of 'characterisation', see Engelen and Pötgens, supra note 132, at p.250.

498 OECD, *The application of the OECD Model Tax Convention to Partnerships*, (Paris: loose-leaf, 1999).

499 Danon, supra note 202, at p.222. For an explanation of these principles in other circumstances see Lang, supra note 135, at pp.596-600.

500 In fact, the OECD considered "a number of possible amendments to the OECD Model Convention that would further develop the analysis set out in the Partnership Report", see OECD, *Public Discussion Draft. BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for Domestic Laws)*, (Paris: loose-leaf, 2014), at p.6.

501 The Report resulted in several additions to the Commentaries to Arts.1, 4 and 23 of the OECD Model Convention.

502 "This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident", Sec.6.3 of Comm. to Art.1 OECD Model Convention (2014).

refrain from taxing[503]. In other words, the State of source does not tax the respective income not because it has renounced the right to tax that income domestically, but only because it is acting 'in accordance with the provisions of the Convention'[504]. In such a case, the new fourth paragraph of Art.23A OECD MC provides:

> "The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax [...]"[505]

Given the fact that the Model has been applied already in order to avoid double taxation by the State of source, the State of residence would not be obliged to grant an exemption on that income. In other words, even though relief has not been provided by the State of residence, double taxation has nonetheless already been avoided 'in accordance with the provisions of the Convention':

> 'The phrase "in accordance with the provisions of this Convention, may be taxed" must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.'[506]

The logic behind the provision indicates that, because of the application of the OECD MC by the State of source, an exemption on the income has been given by that State (because that State has renounced to tax an income which it would have otherwise taxed under its domestic rules). Thus, considering that an exemption has already been given due to the application of the Model (by the State of source), there would be no further need for the State of residence to grant another one. This is what the new paragraph 4 of Art.23A OECD MC provides.

The situation would be radically different if the State of source does not tax the income not because of the treaty, but because of its domestic law. This would occur, for instance, if the State of source renounces its right to tax in order to achieve a certain domestic policy objective, such as the promotion of investment. In that case, if the question were raised of whether two exemptions are being granted due to the application of the Model, the answer would be negative. The State of source would not be granting an exemption due to the application of the Model, but only as a consequence of its domestic law. In that case, the State of residence must apply Art.23A OECD MC

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503 By way of illustration, State S sees the entity as transparent and it attributes the income to its partners, residents in State P. State R, on the contrary, sees the entity as opaque and it attributes the income to the entity. The S-R treaty follows the OECD MC, and there is no treaty between States S and State P. If a company in State S distributes royalties to a partnership in State R, according to the laws of the State of source, the requirement of residence in State R would not be met, and therefore its right to tax would not be restricted by Art.12 of the S-R treaty. Considering that there is no treaty between States S and State P, State S would have applied, under its domestic laws, its full rate of withholding tax to the royalties. Under the solution contained in the Partnership Report, however, State S must follow the characterisation of the entity made by State R. This means that, contrary to its original opinion, it must accept the existence of an entity in State R and apply the S-R treaty accordingly. As a consequence of this, Art.12 of the S-R treaty would be applicable, inasmuch as there is a resident in State R (the partnership) claiming treaty benefits, and the State of source, which would originally have taxed the income, must not apply its withholding tax. This exemption is provided 'in accordance with the provisions of the Convention'.

504 Russo, Raffaele, 'The 2008 OECD Model: An Overview', in 48 *European Taxation* 9 (2008), at p.464.

505 Art.24 para.4 OECD Model Convention (2014).

506 Sec.32.6 of Comm. to Art.23A OECD Model Convention (2014).

to exempt that income[507] regardless of the exemption provided by the State of source. The OECD has expressly clarified this in the Commentaries to the Model:

> "The paragraph [para.4 of Art.23A OECD MC] *only applies to the extent that the State of source has applied the provisions of the Convention to exempt* an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. *The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source*. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source."[508]

The principle of absolute exemption finds, in the new rule of paragraph 4 included by the OECD to Art.23A OECD MC, only a very limited exception[509], something that has been recognised in 2014 in the context of BEPS[510]. According to this rule, once an exemption has been granted due to the application of the Model by the State of source, there is no need to force the State of residence to provide another one. What the rule precludes is, at the outset, the recognition of two exemptions because of the application of the same treaty by both contracting States. If the State of residence contemplates a regime of capital import neutrality, it is rather evident that the rule of Art.23A(4) OECD MC would not forbid the recognition of that exemption[511]. While double non-taxation would inexorably arise in such cases, the rule does not entail a general subject to tax approach[512] because the Model would not oppose that result.

8.4.5. Credit method and tax sparing: Credit when taxes are not paid

As was stated before, when the methods of relief were first studied, a fundamental difference between the exemption and the credit method was observed:

> "The application of the exemption system means that the State which gives up its right to tax a certain income, leaves out that income in determining the taxable income. The application of the credit system means that the State which gives the relief, allows a deduction of tax relevant to the income that is taxed in the other State."[513]

Under the exemption system, whether the income is actually taxed in the State of source is immaterial for the purposes of granting the so-called *relief*. While this did not seem to be possible in States applying a credit system, the OECD nevertheless found it desirable in order to promote cross-border trade and investment:

> "[…] the position was referred to of certain industrially under-developed countries where tax reliefs are granted to encourage new industries. The Working Party were instructed to examine whether the provisions

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507 "Double non-taxation may be perfectly in line with the object and purpose of tax treaties when one contracting state does not have taxing rights and the other contracting state does not exercise its taxing rights for domestic reasons", see Lang, Michael, '"Taxes Covered" – What is a "Tax" according to Article 2 of the OECD Model?', in 59 *Bulletin for International Taxation* 6 (2005), at p.223.

508 Emphasis added. Sec.56.2 of Comm. to Art.23A OECD Model Convention (2014).

509 According to Sasseville, "while Art.23A(4) may apply to prevent double non-taxation in some cases of conflicts of interpretation, it will not address all such cases and is not primarily intended to do so", see Sasseville, Jacques, 'Klaus Vogel Lecture – Tax Treaties and Schrödinger's Cat', in 63 *Bulletin for International Taxation* 2 (2009), at p.46. The fact that the rule entails a subject to tax approach has been promoted by Burgstaller, supra note 464, at p.275.

510 According to the OECD: "[the] States should also recognise that the provision will only provide a partial solution to the problem", see OECD, *Public Discussion Draft. BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Treaty Issues)*, (Paris: loose-leaf, 2014), at p.12.

511 Schaffner, supra note 173, at p.226.

512 Vogel, Klaus, 'Tax Treaty News', in 54 *Bulletin for International Taxation* 3 (2000), at p.99.

513 FC/WP15(59)1, at p.4.

governing the avoidance of double taxation of income should ensure that the benefits of such reliefs would be preserved."[514]

Despite the generic terms of the assignment, the attitude of the OECD towards the issue was not neutral. The difference between exemption and credit was observed mostly from the standpoint of the negative consequences involved in the adoption of the credit system. It was in fact considered that:

> "[…] in some cases a provision in a double taxation Convention may also serve purposes other than the avoidance of double taxation: […] b) Cases where the State of source for special reasons has given up, or reduced, its taxation"[515].

Thus, while the:

> "[…] low rate of taxation might have been introduced in the State of source for some social or other praiseworthy reason […] under the credit system the benefit of the lower rate of tax would only lead to a higher payment of tax in the State of residence and the aim of the relieving legislation in the other State would be defeated."[516]

A solution to this conundrum had to be found. After all, "[i]f a country was given the right to tax, it should also be given the right not to levy the tax for certain economic reason"[517]. Working Party 15 thus released the following statement for discussion:

> 'Conventions for the avoidance of double taxation are designed to assist the removal of obstacles to the free movement of trade and capital between Contracting States. The purpose of a Model Article is to set a headline, for action to be taken between Member States for the removal of obstacles created by double taxation of income. The Working Party consider that "matching credit", while not precisely a question of double taxation is, nevertheless, very closely associated with it; and should therefore be included in the draft Article. The granting of matching credit relief would facilitate the flow of capital between various States.'[518]

The 'matching credit', currently known as the 'tax sparing' clause[519], is a mechanism designed to secure the recognition of a credit in the State of residence, equivalent to the amount of tax that would have been paid at source, as if that State actually collected such tax. The OECD found it desirable to include such a rule in the Model in order to incentive its adoption, even though it would undoubtedly have promoted the operation of the Model in scenarios of non-taxation:

> "[…] it is desirable to give tax relief in the renouncing State irrespective of the fact that the income in question is not taxed in the other State. This cannot be accomplished if the credit system is applied, as this system only operates if there is an actual taxation in both States. […] What is needed is to effect a change in a position which, as it stands, enables certain tax relief benefits given in one State to enure (sic) to the benefit of the Exchequer of the other State, and not to the benefit of the taxpayer. Such a change should ensure that the taxpayer does secure the benefits. To achieve this end it is necessary to apply rules which are contrary to the fundamental principle of the ordinary credit system, according to which the renouncing State is only to allow a deduction corresponding to the smaller of the tax amounts which are actually payable in the two States. […]
>
> Consideration has been given to the idea that, instead of allowing as a deduction only the tax actually paid, there should, under certain circumstances, be allowed as a deduction an amount corresponding to the taxes which should have been paid in the State of source if no relief had been granted by this State."[520]

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514 FC/WP15(59)1, at p.1.
515 FC/WP15(59)1, at p.14.
516 FC/WP15(59)1, at p.15. The need existed to "avoid nullification of incentives granted by underdeveloped countries", see TFD/FC/142, at p.4.
517 FC/M(60)3, at p.5.
518 FC/WP15(59)1, at p.16.
519 Sec.73 of Comm. to Art.23 OECD Model Convention (2014).
520 FC/WP15(60)1, at p.4.

The only reason why the final version of Art.23 OECD MC did not contain a tax sparing clause was the inability of the OECD to persuade the States to include such a rule in the Model. After quite a long debate, the Fiscal Committee had to instruct the Working Party "not to include a provision concerning this question in the Article but to deal with the question in the Commentary"[521], not without stating that its inclusion in the Model would have guaranteed "satisfactory results."[522]

It is true that OECD's opinion in relation to these clauses has notoriously changed as a result of the latest concerns in the field of tax treaty abuse[523]. The Commentaries to Art.23 OECD MC were in fact drastically amended in 2000 to present tax sparing as a dangerous provision, which entails a significant risk of abuse. The change of attitude, however, is quite recent. The obvious question the history of the credit mechanism entails is that of the policy objective pursued by the OECD while discussing the rules of relief. Under a tax sparing system there would certainly be no effective double taxation being avoided. On the contrary, it is rather evident that the Model would have resulted in overall non-taxation. Still, the OECD wanted to grant *relief*, if it can be called that way, in the absence of any tax burden.

If one adds to the absolute obligation to provide exemption the pressure put by the OECD to include a matching credit in the Model, then it is clear that effective taxation as a condition for tax treaty benefits was not only outside the OECD's agenda but, on the contrary, it was a policy objective the OECD did not intend to embed into its Model. The clearest evidence of this lies in the outcome of the discussion held at Working Party 15. The solution to the mismatch between the exemption and the credit systems appeared to be simple: the Fiscal Committee knew that a change from 'may be taxed' to 'subject to tax' in Art.23 OECD MC was needed, because it had been proposed[524]. Yet, once the negative of the Delegates to accept the inclusion of a tax sparing clause in the Model was clear, the mismatch between credit and exemption was conveniently forgotten. The OECD did not rectify the rules of exemption in order to re-establish the balance between the mechanisms of credit and exemption, but it left them untouched. Hence, the difference was significant and relevant only to the effect that the credit system had to be adapted to the exemption system (in order to secure non-taxation), but not for the reverse case, which would have demanded effective taxation in order to obtain treaty benefits. Exemption was not to be equated to the credit system, because the OECD saw double non-taxation as something desirable from a policy point of view.

8.4.6. Evaluation: 'Liable to tax' and effective residence taxation

Both the history of the Model and its current wording demonstrate beyond any doubt that effective taxation is not a condition the OECD had in mind in order to accept the presence of treaty entitlement or the appropriateness of relief. The subject was a matter of extensive discussion, and the policy the OECD sought to implement appears to be clear. Thus, the ordinary meaning of the term 'liable to tax' ought not be construed by taking effective taxation as a condition for it.

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521 FC/WP15(60)2, at p.1. For the discussion which led the Delegates to place the recommendation in the Commentaries see FC/M(60)3, at pp.4-6.

522 FC/WP15(60)2, at p.19.

523 OECD, *Tax Sparing: A Reconsideration (Adopted by the OECD Council on 23 October 1997)*, (Paris: loose-leaf, 1998). See also sections 72 to 78.1 of Comm. to Art.23 OECD Model Convention; and for an analysis of the convenience of tax sparing clauses in the context of the OECD Report, see Meirelles, Morvan, 'Tax Sparing Credits in Tax Treaties: The Future and the Effect of EC Law', in 49 *European Taxation* 5 (1999).

524 FC/M(60)1, at p.9. This represents the conviction expressed by the OECD, but it is not clear whether this measure would have solved the problem, see de Broe, supra note 459, at p.73.

The situation is crystal clear in the case of States applying the exemption system. There are no reasons to compel these States to interpret the term 'liable to tax' as to require the payment of taxes in order to grant the benefits of the treaty, for the obligation to provide exemption is an absolute one. The case of States applying a credit method, on the other hand, is exceptional, to the extent that the method of relief prevents the occurrence of double non-taxation. This, however, does not affect the meaning of the expression 'liable to tax' in the Model, but it is only a consequence of the manner in which the domestic credit rules operate. There simply cannot be credit if taxes are not paid. The States however, as the history of the Model indicates, can *put a remedy to that problem*[525] by including a tax sparing provision in their tax treaties.

If one looks closely to the policy considerations behind the debates held at the OECD, the application of the Model in cases of non-taxation was neither random nor the product of a misinterpretation, but a well thought-out strategic decision. There is no other reasonable way to explain the proposal to include a tax sparing rule in the text of the Model, and all the different but concurring explanations as to the effect of the exemption system. The irrelevance of taxation for the purposes of treaty entitlement was nevertheless a consequence of the structure of the OECD MC. One cannot hope the situation to be different in a treaty where the income plays little role and where the rules of domestic law on residence needed to be strictly followed.

When studying tax treaty entitlement in cases of exemption, a distinction can be made between subjective exemptions (granted to a specified person), and objective exemptions (which aim at the situation of the income). While some authors do not see the problem in accepting the tax liability of a person who receives tax-exempt income, they struggle to accept that a tax-exempt person may be considered to be 'liable to tax'[526]. However, the broad terms in which the absolute obligation to provide exemption has been formulated tend to favour the hypothesis that the distinction is immaterial[527]. Thus, each time a charity, a tax-exempt pension trust or a religious entity is under scrutiny, before making any judgments, one needs to look at the laws of the relevant State, to check whether they grant that person the status of resident therein. The circumstances of the income received, under the rules of the Model, do not play any role, let alone its taxation. Courts, therefore, should not be so quick to exclude these entities from obtaining tax treaty entitlement.

Similar considerations apply to the situation of tax treaty abuse in the field of BEPS. In its latest work the OECD has timidly implied that a person may abuse the provisions of domestic law by using tax treaties. In particular, it has identified:

> "Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the State of source but must be exempted by the State of residence or by abusing foreign credit mechanisms)."[528]

Yet it is fairly clear that, according to what has been stated earlier, the context of the rule of residence and the policy embedded into it clearly describe a tax liability for the purposes of which

[525] FC/M(60)3, at p.5.

[526] 'It seems clear that a person does not have to be actually paying tax to be "liable to tax" otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the convention. [On the contrary] a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, *if the exemption were repealed, or the person no longer qualified for the exemption*', emphasis added, see Baker, Phillip, *A Manual on the OECD Model Tax Convention on Income and on Capital*, p.4B.05.

[527] As concluded by van Weeghel, when commenting a ruling by the Supreme Court of the Netherlands, *case No. 07/10383*, BNB 2010/177, 4 December 2009, Tax Treaty Case Law, IBFD.

[528] OECD, Public Discussion Draft, *BEPS Action 6*, supra note 27, at p.87.

effective taxation is not at all necessary. The question therefore as to whether there is an abuse of the relief mechanisms cannot simply ignore the consistent propensity to favour non-taxation in the integrity the Model, under the guise of defending a politically correct speech, which is that against profit shifting.

To sum up, it is one thing to say that this is the manner in which the law has been designed and quite another thing to admit that the law generates an appropriate result. While it is indeed right from a policy perspective that a tax-exempt pension trust enjoys the benefits of the Model even if it pays no taxes, this does not seem to be reasonable if it occurs in the case of a MNE which sets out a strategy of profit shifting. The law, however, is in principle what the law is and not what it should be. Double non-taxation has caught immense media attention because of the fact that MNE have gone untaxed or under taxed while making enormous amount of profits. This does not seem to be fair from a number of angles, but it is nonetheless doubtful whether the success of these claims, under the rules of the Model as they stand, could soon be brought to a halt.

8.5. OECD proposals to achieve a subject-to-tax approach

The OECD MC has been provided with several alternatives to achieve a subject to tax approach. The addition of subject-to-tax clauses[529], rules for income that is subject to low or no tax[530] and rules on remittance-based taxation[531] are but examples of proposals aimed to making treaty entitlement subject to effective taxation. These rules generically provide that access to treaty benefits would be recognised "if the *income in question* is subject to tax"[532]. The focus of the rules lies in the taxation of the income, thus changing radically the subjective structure of tax treaty entitlement in the Model. It is perhaps for this reason that they were added to the Commentaries to Art.1 OECD MC instead of the Commentaries to Art.4 OECD MC. Arguably, they are meant to supersede the rule of residence when included in a tax treaty.

The pertinence of the subject to tax approach has also been discussed in cases of conduit companies[533]. However, the OECD has acknowledged that the inclusion of such rules does not provide enough guarantees against advanced tax avoidance schemes such as "stepping-stone strategies"[534]. From the point of view of the issue the clause is intended to deal with (non-taxation), it is clear that a subject to tax rule aims at securing the operation of tax treaties in a context of double taxation or, expressed in a different way, they seek to prevent non-taxation[535]. The rule does not aim to detect and counter treaty entitlement in artificial scenarios, which is an essentially different issue. Furthermore, as has been argued before, an excessive focus on the income would render the rule of residence even narrower, leaving outside the scope of the Model certain persons whose treaty entitlement would be desirable from a policy perspective. The relevant aspect to determine the suitability of treaty benefits in this case is the presence of an economic nexus with a State, but that is a rather diverse concern, which is not properly determined by the presence of taxation.

From a general standpoint, the existence of these proposals in the Commentaries sheds light on the ordinary meaning to the term 'liable to tax' by strengthening the conclusion that effective

529 Subject-to-tax clauses were incorporated to the OECD MC's Commentaries in 1992. See Sec.15 of Comm. to Art.1 OECD Model Convention (2014).
530 Sec. 21.3 of Comm. to Art.1 OECD Model Convention (2014), included in 2003.
531 Sec. 26.1 of Comm. to Art.1 OECD Model Convention (2014), included in 2003.
532 Emphasis added. Sec.15 of Comm. to Art.1 OECD Model Convention (2014).
533 Sec.15 of Comm. to Art.1 OECD Model Convention (2014).
534 Sec.16 of Comm. to Art.1 OECD Model Convention (2014).
535 Burgstaller, supra note 464, at p.266.

taxation is not relevant for the purposes of treaty access. If such a meaning could be attributed to the term by following a certain interpretation of the Model, there would simply be no place for these provisions in the text of the Commentaries.

8.6. Tax liability absent effective taxation: 'Liable to be liable to tax'

The analysis of effective taxation in the context of Art.4 OECD MC suggests that the Model refers to a person who is subjugated to the tax authority of a certain State, but in respect of whom that authority needs not to be exercised. Under this formula, it is enough if the treaty claimant is "liable to be liable to tax"[536], in the sense that "the person is subject to the possibility of becoming exposed or subject to tax."[537] This conclusion would converge with everything that has been said so far in relation to the attribution of an ordinary meaning to the term 'liable to tax'. At the outset, tax liability refers "to the connecting factors of a person with a contracting state that are used by that state to impose unlimited taxation, but it is not a requirement that the person who has such connecting factors actually be subject to unlimited taxation if the domestic law relieves him of some or all tax on his income"[538].

Several courts have followed this interpretation. In the *Azadi Bachao Andolan* case[539], treaty entitlement in the case of tax-exempt income was recognised:

> '[…] the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the [treaty], what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the [treaty] would not have used the words, "liable to taxation", but would have used some appropriate words like "pays tax"'[540].

Tax treaty entitlement has been recognised in the case of tax-exempt persons as well. In the *Green Emirate Shipping* case[541], the claimant was not even subject to corporate taxation in the relevant State[542]. The court nonetheless concluded that once the right to tax had been vested to one of the contracting States, it is that State which must decide whether to exercise that right or not, regardless of the situation of its counterparty[543]. At the outset:

> "[…] being liable to tax in the Contracting State does not necessarily imply that the person should actually be liable to tax in that Contracting State by the virtue of an existing legal provision but would also cover the cases where that other Contracting State has the right to tax such persons irrespective of whether or not such a right is exercised by the Contracting State"[544].

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536 Couzin, supra note 20, at p.107.
537 Couzin, supra note 20, at p.107.
538 See Ward et al., supra note 13, at p.422; Maisto, Guglielmo, 'Italy. Residence of Individuals and the Italy-France Tax Treaty', in 39 *European Taxation* 2 (1999), at p.47;
539 *Azadi Bachao Andolan*, supra note 25.
540 *Azadi Bachao Andolan*, supra note 25.
541 *Green Emirate*, supra note 25.
542 In that case, a United Arab Emirates (UAE) company claimed the benefits of the tax treaty with India in relation to income that was not to be taxed in the UAE. The UAE, however, imposed a corporate tax only to oil companies and banks at that time.
543 As has been said, "[…] irrespective of whether or not the UAE actually levies taxes on non-corporate entities, once the right to tax UAE residents in specified circumstances vests only with the Government of UAE, that right, whether exercised or not, continues to remain exclusive right of the Government of UAE [because] taxability in one country is not *sine qua non* for availing relief under the treaty from taxability in the other country", see *Green Emirate*, supra note 25. This situation resulted in the inclusion of a limitation-on-benefits clause in the treaty, see Vogel, Klaus, 'Tax Treaty News', 62 *Bulletin for International Taxation* 2 (2008), at p.49. See also Hull, supra note 142, at pp.60-61.
544 *Green Emirate*, supra note 25.

Similarly, in the *Mohsinally Alimohammed Rafik* case[545], the treaty entitlement of an individual resident in the United Arab Emirates (UAE) was accepted, even though the UAE did not impose any individual income tax[546]. The principles embedded in these rulings have been ratified by many other judgments[547].

The attempts of the tax authorities to make a case for requiring effective taxation in order to recognise treaty benefits are often rejected by the courts[548]. In the *Gladden* case, it was stated that the treaty claimant "can benefit from the exemption regardless of whether or not he is taxable on that capital gain in his own country"[549]. In a Swedish case, tax treaty entitlement was recognised in the case of companies which were declared exempt from tax years after the relevant treaty had been concluded[550]. It is thus clear that, according to the courts, whether the exemption is granted at the level of the income or of the person, and even after the conclusion of the treaty is irrelevant: the obligation to provide exemption is an absolute one[551].

There are always, however, dissident opinions. In an Italian case, the court denied the benefits of a treaty because the dividend distributed from the subsidiary to the parent was not subject to withholding tax in the State of source[552]. While this can be criticised from a number of angles[553], the main critique that can be made to this ruling is that it flagrantly contradicts the suggestions given by the OECD in the Commentaries. The outcome of the case is in fact contrary to the principle of exemption recognised in the Model. Further, some of the thoughts of the court in the

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545 *Mohsinally Alimohammed Rafik*, supra note 306. This case has been confirmed by several other rulings, see *Mahavirchand Mehta*, supra note 306; *Mushtaq Ahmad Vakil,* supra note 306; *Meera Bhatia*, supra note 306.

546 This situation was commented by Vogel, see Vogel, supra note 25, at p.419; Vogel, Klaus, 'Tax Treaty News', 60 *Bulletin for International Taxation* 6 (2006), at p.218; Vogel, Klaus, 'Tax Treaty News', 62 *Bulletin for International Taxation* 2 (2008), at p.49.

547 *Mushtaq Ahmad Vakil,* supra note 306; Income Tax Appellate Tribunal (ITAT) Mumbai, 19 January 2011, *Crown Capital Limited v. ADIT*, (2011) TII 21 (ITAT MUM); Income Tax Appellate Tribunal (ITAT) Mumbai, 29 October 2010, *The Hong Kong & Shanghai Banking Corporation Limited v. DDIT*, (2010) 10 TMI 610 (ITAT Mumbai); Income Tax Appellate Tribunal (ITAT) Mumbai, 29 October 2010, *Frate Line, Dubai v. ADIT*, (2010) TII 166 (ITAT MUM); Income Tax Appellate Tribunal (ITAT) Mumbai, 30 September 2010, *Birla Sunlife Management Co. Ltd. V. ITO*, (2010) TII 125 (ITAT MUM); Income Tax Appellate Tribunal (ITAT) Mumbai, 25 November 2009, *Hindustan Petroleum Corporation Ltd. V. ADIT*, (2010) TII 16 (ITAT MUM); see *Meera Bhatia v. Income Tax Officer*, supra note 306

548 Treaty benefits were denied by the AAR in India to an individual claiming entitlement to the India UAE tax treaty, based on the lack of and individual income tax and in the fact that the individual failed to provide any evidence to prove he was a resident of the UAE. Authority for Advance Rulings New Delhi, 19 May 1999, case No. 385 *Cyril Eugene Pereyra*, (1999) 239 ITR 650 (AAR). As the AAR stated in that case, "the provisions of the Double Taxation Avoidance Agreement do not apply to any case where the same income is not liable to be taxed twice by the existing laws on both the Contracting States". The ruling in *Cyril Eugene Pereira* was later confirmed by the same Authority for Advance Rulings New Delhi, 30 July 1999, case No. 34 and 35 *Individual, name not disclosed v. CIT*, (2002) TII 60 (ARA). However, the Supreme Court denied any binding effect to these rulings, see *Azadi Bachao Andolan*, supra note 25.

549 Treaty entitlement was initially denied to a US resident making a capital gain in Canada, because of the fact that at the time of the taxable event, no taxation of capital gains was imposed under Canadian domestic law. According to the Court's conclusion, "[i]f Canada or the U.S. were to abolish capital gains completely, while the other country did not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country", see *The State of the Late John N. Gladden,* supra note 89.

550 Regeringsrätten (Supreme Administrative Court) Sweden, 2 October 1996, *Case RÅ* 1996 ref. 84 (6301-1994).

551 The Netherlands, Supreme Court, 21 December 1994, *Case 28.953*, BNB 1995/143c; The Netherlands, Supreme Court, 4 December 2009, *Case 08/05071*, V-N 2009/62.5.

552 Italy, Tax Court of Turin, *case number 148/11/2010*. The case involved the application of the Germany-Italy tax treaty and the Parent-Subsidiary Directive. Dividends were distributed from a German subsidiary to its Italian parent. Insofar as the Directive prevented any withholding tax to be levied in Germany, the court denied the exemption contained in the treaty.

553 Tripoli, Paolo, 'Turin Tax Court Denies Treaty Residence State Dividend Exemption Absent Source Taxation', 51 *European Taxation* 6 (2011), at p.262.

Sportsman case are equally incompatible with the policy underpinned by the OECD in the Commentaries:

> "Double taxation conventions have been entered into by governments for a practical purpose and that is to relieve the burden of actual taxation of the same income in more than one country. There would be no practical purpose in the prevention of double assessment. What matters is not the existence of a liability but a crystallisation of that liability by payment."[554]

While one cannot but agree with the fairness of the court's reasoning, both the history and the text of the Model and the Commentaries suggest that this is not the case. On the contrary, actual taxation was not considered by the OECD in order to set the rules according to which the benefits of the Model can be claimed[555]. All that the OECD MC requires is a person who is subjugated to the tax authority of a State, with the possibility of that authority being exercised at a certain point in time.

8.7. Evaluation: Tax liability and effective taxation under the rules of the OECD MC

The meaning of the term 'liable to tax' in the context of the Model does not require effective taxation for its benefits to be availed of. On the contrary, the policy objective behind the Model in relation to effective taxation is quite clear: the OECD not only accepts but also promotes the operation of the OECD MC in scenarios of non-taxation. This occurs from the perspective of the State of source, which may not deny the benefits of a tax treaty under the guise of the treaty claimant not being subject to an effective tax burden in the State of residence, and *vice versa*. The State of residence cannot deny the benefits of the Model if the State of source refrains from taxing a given tax treaty claimant.

It is essential to understand the effect of this configuration when seeking to attribute its meaning to the term 'liable to tax' in the Model as it stands. In principle, effective taxation or the lack of it should not operate as a relevant factor for the purposes of recognising tax treaty entitlement. All the Model requires is the submission of a person to the tax authority of a State, and thus all a person needs to succeed in claiming the benefits of a tax treaty is to be 'liable to be liable to tax'[556]. Regardless of the fact that taxes having actually been paid may be relevant in States applying the credit system, this is not a consequence of the Model requiring effective taxation to operate, but it is only an effect of how the credit mechanism works. If one reads the history of the Model, there were several attempts by the OECD to introduce a tax sparing clause in its text, which is quite enlightening when seeking to unravel the policy considerations which drove its drafting.

Arguably, these conclusions also bear fundamental consequences for the analysis of what the object and purpose of tax treaties may be, analysed in a subsequent part of this work. While it is relatively clear that the Model aims at the avoidance of double taxation, any attempt to sustain

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[554] *Sportsman*, supra note 23, at para.6.9.

[555] Vogel, supra note 6, n.24a, at p.229; Kleist, David, 'Treaty Entitlement of Tax Exempt Entities', 36 *Intertax* 6/7 (2008), at p.267; de Graaf, supra note 208, at p.172; Salom, supra note 298, at p.400.

[556] See Couzin, supra note 20, at p.107. In line with the idea that the term 'liable to tax' cannot be construed as a subject to tax clause, see Lang, Michael, *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs*, (London: Kluwer, 2000), at p.55; Vogel, *supra* note 6, n.24, at p.229; Danon, supra note 202, at p.219. This is also the view of many States in relation to companies: Austria, see Simader, supra note 118, at pp.359-360; Belgium, see Bammens, supra note 303, at p.393; France, see de Boynes, supra note 172, at p.453; Germany, see Englisch, supra note 102, at p.497; Italy, see Tenore, supra note 237, at p.547; the Netherlands, see de Boer, supra note 141, at p.583; South Africa, see Hattingh, supra note 235, at p.716; Spain, see Martinez, supra note 235, at p.779; Switzerland, see Maraia, supra note 223, at p.810; and the United States, see Brauner, supra note 111, at p.877.

that this also implies the need to prevent non-taxation would not be supported from the perspective of its text, and sustaining this interpretation would render important sections of the Model and the Commentaries meaningless[557]. The absolute obligation to provide exemption, for instance, cannot be dishonoured by simply promoting a certain interpretation of its rules. When trying to determine the object and purpose of tax treaties from the perspective of the subject entitled to its benefits, the setting of the OECD MC in this sense cannot be ignored.

[557] Most of these sections have been quoted and described in Chapter 8, when explaining the fact that the rules of the Model do not require effective taxation for the purposes of tax treaty entitlement. By way of illustration, Sec.3 of Comm. to Art.21 OECD Model Convention (2014) may be mentioned, and also Sec.35 of Comm. to Art.23 OECD Model Convention (2014), imposing the *absolute obligation to provide exemption*, amongst others.

9. Chapter 9
The ordinary meaning of 'liable to tax' under the VCLT and the object and purpose of tax treaties

9.1. Introduction

According to what has been said so far, the difficulties derived from the definition of residence in the context of tax treaties are mainly two. Either the concept is too broad, and thus incapable of rejecting certain claims the appropriateness of which is debatable, or it is too narrow, for some claims which appear to be desirable from a policy perspective are nevertheless rejected from the standpoint of its text[558]. Both types of difficulties have a common origin. They derive from the confusing and sometimes conflicting elements through which the OECD has explained the meaning of the term 'liable to tax'.

Despite all these apprehensions, it is nevertheless clear that the term must be attributed its meaning, for the application of tax treaties depends on that. However, the manner in which one must do so is also quite confusing. Literature tends to define the term 'liable to tax' in a certain way, depending on the election made as to the object and purpose of tax treaties. As has been mentioned before, to some the Model is meant to avoid double taxation, and thus the term 'liable to tax' is defined as 'taxed'. Others conceive tax treaties as instruments for the allocation of tax jurisdiction and therefore define 'liable to tax' as 'liable to be liable to tax'. This has been the traditional manner in which some issues like treaty shopping[559] and non-taxation[560] have been faced, although continuously and regrettably in an unsuccessful manner.

One cannot ignore the fact that the rules of public international law for the interpretation of tax treaties contain a process that is much more complex when attempting to attribute its meaning to a treaty term. Under the Vienna Convention on the Law of Treaties (also referred to as "VCLT"), a series of guidelines need to be followed.

In the subsequent lines, the many elements explored so far will be thrown into the crucible in an attempt to define the term 'liable to tax' in the context of the Model, using the VCLT as a guide. Moreover, this part is also meant to discuss to what extent and the manner in which the definition of residence has an impact on the determination of the object and purpose of tax treaties.

9.2. If only the OECD had left residence undefined

Considering that the term 'liable to tax' is usually appointed as the keystone in relation to all the issues in the field of treaty residence[561], and that the OECD intended to leave the matter of residence to the laws of the States, one cannot help but wonder whether a more straightforward formula would have been better. Under most of the Australian tax treaties[562], for instance, the definition of residence is of striking simplicity:

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558 Vogel, supra note 25, at p.418.

559 Duff explains the failure to confront treaty shopping from this perspective, see Duff, supra note 157, at pp.81-82. This aspect of the definition is further analysed in Chapter 10.

560 *Sportsman*, supra note 23, at para.6.9; see also United Kingdom, 23 March 2011, *Bayfine UK v. The Commissioners for Her Majesty's Revenue and Customs*, [2010] EWHC 609 (Ch), at para.40. For a response see Federal Tax Court Canada, *The State of the Late John N. Gladden*, supra note 89, at para.20.

561 See de Graaf, supra note 208, at pp.169-177.

562 This model rule is used in 40 out of 42 tax treaties, and the remaining two rules do not strictly follow the model rule proposed by the OECD, see Dirkis, when commenting corporate residence, supra note 83, at p.332.

> "For the purposes of this Agreement, a person is a resident of one of the Contracting States if the person is a resident of that State under the law of that State relating to its tax"[563].

This formula was implemented to avoid the difficulties derived from the use of the expression 'liable to tax'[564] and at the same time refer to the domestic law meaning of residence for treaty purposes. However, there is no assurance that such a definition would provide the ultimate answer to the many issues derived from the use of that expression.

By way of illustration, if in the context of a treaty using that formula the question were raised as to the possibility of denying treaty benefits absent effective taxation, there would no straight answer. On the one hand, it may be argued that treaty benefits should not be denied because residence is based on domestic law and domestic law does not impose taxation for those purposes. On the other hand, it may also be sustained that the application of the treaty would be pointless, as there would be no double taxation to be avoided. The former position, however, requires the need of interpreting the treaty in a certain manner; for instance, under the argument that the treaty has some sort of superior objective that prevents its operation (i.e. the treaty does not apply because there is no double taxation to be avoided). This position presupposes the existence of certain elements in the treaty that are capable of introducing a crucial deviation from domestic law.

This hypothetical construction suggests that the problems derived from the application of Art.4 OECD MC do not solely arise from the use of the term 'liable to tax', but from the manner in which tax treaties have been structured, in general, in relation to the term 'resident'. Even if the OECD had not used the term 'liable to tax', most of the disquieting issues allegedly derived from its presence would probably still persist.

Perhaps the only manner to truly avoid the issues derived from the use of the term 'resident' would be to understand that the treaty definition is not meant to set any standards for domestic residents to access tax treaties. In other words, one would have to conclude that the use of a domestic definition implies that the States are left free to exercise the right to tax allocated by the treaty at their own discretion. This would imply that no further requirements exist, or should be implied in any respect to be entitled for treaty benefits, which seems to be in line with the Australian position[565]. The Australian tax authorities have in fact pointed out that: "[...] a country is never required by a DTA to exercise a taxing right under that DTA if it does not wish to."[566] More importantly:

> "As well as not dictating that the allocated taxing rights must be exercised by a country, DTAs also do not [...] dictate how they are to be exercised. Whether and how those rights are exercised is usually left to the respective ordinary domestic laws (that is, the domestic laws other than the DTA as domestically implemented). It is therefore possible, and unexceptional, to have a situation where there is a right under a

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563 Australia – Argentina Income Tax Treaty (1999). The same or a substantially similar definition is used in other treaties. By way of illustration, the relevant provision in the Australia – Belgium treaty (1984) states: "For the purposes of this Agreement, a person is a resident of one of the Contracting States: (a) in the case of Australia, [...] if the person is a resident of Australia for the purposes of Australian tax; and (b) in the case of Belgium, if the person is a resident of Belgium for the purposes of Belgian tax." This formula is analysed by Couzin, supra note 20, at p.105.

564 Australia does not use the term 'liable to tax' in tax treaties to avoid the problems derived from the interpretation of the term, see Dirkis, when commenting corporate residence, supra note 83, at p.332, and in relation to individuals, Dirkis, supra note 83, at p.230. This formula has apparently been successful considering that "few problems which arise under such agreements reach the courts", see Hill, Graham, 'The Interpretation of Double Taxation Agreements – The Australian Experience', in 57 *Bulletin for International Taxation* 8 (2003), at p.320.

565 Dirkis, in relation to companies, supra note 83, at p.359.

566 Australian Taxation Office, Taxation Ruling 2001/13, Income Tax: Interpreting Australia's Double Tax Agreements, at p.8. This ruling is commented by Vogel, see Vogel, Klaus, 'Tax Treaty News', in 56 *Bulletin for International Taxation* 6 (2002), at p.226.

> treaty to impose a form of taxation, but where the legislature has not decided to impose (or has positively decided not to impose) such a tax liability under domestic law. A future legislature may pass legislation exercising the right, and that would be consistent with the treaty."[567]

Australia has decided to adopt a fully domestic definition of residence, recognising the sovereign right of each State to grant the status of treaty resident to any person who may be suitable from a policy perspective. Yet regardless of their straightforwardness, the Australian approach also raises some fundamental questions in the field of tax treaties.

Firstly, one may wonder whether there is a meaningful purpose in entering into a treaty *for the avoidance of double taxation*[568] if the rule of residence recognises, without any objection, treaty entitlement to tax-exempt persons. Secondly, if so, then it would be reasonable to discuss whether tax-exempt residents of Australian treaty partners claim the benefits of such conventions in bad faith or in an abusive manner. Thirdly, it may also be legitimate to debate whether treaty entitlement can be denied in cases of treaty shopping, provided that the alleged conduit company was incorporated in an Australian treaty partner that recognises residence only on the basis of incorporation.

The Australian position strengthens the argument that a fully domestic definition of residence is only congruent with a treaty that merely acts as a tool for the allocation of tax jurisdiction. In such a case, it is the domestic definition of residence that sets out the standard of appropriateness for a tax treaty claim. Further, this position also demonstrates that irrespective of the fact that the presence of the term 'liable to tax' intensifies the issues derived from the application of Art.4 OECD MC, these problems are more of a conceptual nature, and they do not arise from the use of that particular expression.

9.3. Residence: Defining a treaty term through an undefined treaty term

It is worth considering whether the Australian position in relation to the application of tax treaties would change if the wording of Art.4 OECD MC were used. The most probable answer is that, at least policy-wise, it would remain unaltered[569]. However, given the structure of Art.4 OECD MC, in order to continue to speak of an absolute redirection to domestic law in terms of residence, one would have to assume that 'liable to tax' means 'residence' at the domestic level, when the situation is actually the reverse: it is residence that, in the sphere of Art.4 OECD MC, *means* 'liable to tax'.

Bearing in mind the structure of Art.4 OECD MC, it should not bluntly be assumed that 'liable to tax' means residence as conceived by domestic law[570]. A decision was in fact made by the OECD not to use the Australian formula in the Model[571], which suggests that 'liable to tax' and 'residence' were not considered as interchangeable concepts. While the OECD MC has indeed taken domestic residence as a point of departure, Art.4 OECD MC introduces a second step for a construction of treaty entitlement. One needs to analyse whether a person, whose domestic residence has already

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[567] Australian Taxation Office, supra note 566, at p.12.

[568] Australian Taxation Office, supra note 566. As it may be concluded from the title of the ruling and from the sections quoted above, despite the fact that the parties may decide not to exercise the right to tax attributed to them, the tax authorities nonetheless refer to these agreements as 'DTA' or 'double taxation agreements'.

[569] According to the Australian Tax Authorities, "the network of DTAs is not drafted in an absolutely uniform manner in relation to residents of all treaty partners [however] differing wording in two DTAs may represent the same intended meaning", see Australian Taxation Office, supra note 566, at p.16. The term 'liable to tax', however, has not been considered by the courts, see Dirkis, when analysing residence of individuals, supra note 83, at pp.230-231.

[570] Lang, supra note 135, at p.597.

[571] TFD/FC/231, at p.7; and DAF/FC/71.5, at pp.2-3.

been verified (the first step), is also *liable to tax* in that State (the second step). Under domestic rules the first question is not so hard to elucidate, insofar as the laws of the States normally enumerate the cases in which a person is granted the status of resident. The problem arises with the second question, inasmuch as the meaning of the term 'liable to tax' needs to be discovered at the level of tax treaties.

As an undefined treaty term, 'liable to tax' pleads for the application of Art.3(2) OECD MC, according to which the meaning of a term must be sought under the domestic rules of the State applying the treaty[572]. Yet, as was stated before, Art.4 OECD MC sets out an exception to the reasoning behind Art.3(2) OECD MC, and the term must be assigned its meaning not under the laws of the State *applying the treaty*, but exclusively under the laws of the State of residence[573].

The application of this logic is indeed undermined by the fact that hardly any State defines 'liable to tax' in its laws[574], and therefore, the need arises to look for an autonomous definition of the term[575] in order to assign the expression a common meaning[576]. Once the ordinary meaning of the term 'liable to tax' has been found, one would have to verify whether the domestic rules of residence of that particular country overcome the test imposed by the common meaning of the expression. This would provide an answer to the second question: whether the domestic resident is in fact *liable to tax* therein.

While this approach would coincide with what has been said so far in relation to the structure of the definition, if the meaning attributed to the term 'liable to tax' were indeed capable of excluding certain treaty claims from the scope of the Model, then this would render the intention of the OECD not to create standards for domestic residents to access the Model meaningless.

Regardless of how cautious the Fiscal Committee and the Four Economist recommended to be in relation to the use of uncommon expressions, the OECD, well aware of the difficulties related to the term 'liable to tax'[577], nonetheless decided to use it. The complexity of the approach followed by the OECD lies in the fact that, in order to define whether or not the Model is to be applied, the term 'liable to tax' must be given a common meaning. In facing such a cumbersome undertaking, the rules of the Vienna Convention on the Laws of Treaties become crucial[578].

9.4. The ordinary meaning of 'liable to tax' in the light of the Vienna Convention on the Law of Treaties

9.4.1. Introduction

Well aware of the traditional difficulties in relation to the rules on interpretation of international agreements[579], the United Nations, through the International Law Commission[580] (ILC), decided to

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572 Art.3(2) of OECD Model Convention. See also Vogel, supra note 6, at pp.51-60.

573 See supra Chapter 3, at pp.34ff.

574 Engelen in fact notices that one of the difficulties in applying the rule of Art.3(2) OECD MC lies in the fact that the rule "only applies to terms that have a specific legal meaning under the domestic laws of a contracting State", see Engelen, supra note 448, at p.550.

575 Vogel, supra note 6, nn.101a-101b, at pp.59-60.

576 Engelen points out that the impossibility of applying Art3(2) OECD MC due to the absence of a domestic definition leads necessarily to the application of the VCLT, see Engelen, supra note 448, at p.550.

577 FC/M(57)2, at pp.5-6.

578 Engelen, supra note 448, at p.550; Vogel, supra note 6, at p.37; Kandev, supra note 132, at p.55.

579 At the time the issue was considered, "[t]he majority of cases were concerned with the interpretation of treaties" see United Nations, Survey of International Law in Relation to the Work of Codification of the International Law Commission, Doc. A/CN.4/1/Rev.1, (New York: loose-leaf, 1949), at p.52.

analyse the possibility of codifying those rules[581]. This process, which formed part of a colossal effort to systematise the rules of international law in general[582], resulted in the creation of Arts.31, 32 and 33 of the VCLT, which deal with the interpretation of treaties. The purpose of setting up those rules was neatly expressed by the ILC:

> "Admittedly, the task of formulating even these rules is not easy, but the Commission considered that there were cogent reasons why it should be attempted. First, the interpretation of treaties in good faith and according to law is essential if the pacta sunt servanda rule is to have any real meaning. Secondly, having regard to doctrinal differences concerning methods of interpretation, it seems desirable that the Commission should take a clear position in regard to the role of the text in treaty interpretation"[583].

The process of codification was meant to provide clarity[584] and to introduce elements of good sense and logic for a reasonable interpretation of treaties[585], considering that their interpretation "is to some extent an art, not an exact science."[586] The authority of the VCLT to set out the process of treaty interpretation is nowadays unquestionable, and so has been recognised in the specific area of tax treaties[587]. One must therefore consider these rules in order to assign its meaning to the expression 'liable to tax'.

9.4.2. The general rule of interpretation of the VCLT: Integration approach

The primary rule of international law dealing with treaty interpretation is laid down in Article 31(1) VCLT, according to which "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose"[588].

Three principles coexist in this provision[589]. Firstly, interpretation of treaties may be done in good faith, and good faith is but a manifestation of the principle of *pacta sunt servanda*. Secondly, the words of a treaty must be attributed their ordinary meaning[590], and this meaning will determine their interpretation. Thirdly, the ordinary meaning of the words of a treaty should be determined in the context of the treaty and in the light of its object and purpose. These three principles are not to be observed separately, but there must be a harmonious application: "All the various elements, as they were present in any given case, would be thrown into the crucible, and their interaction would give the legally relevant interpretation."[591]

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580 The United Nations created the International Law Commission in 1947 to deal with international law.

581 The codification of the rules of international law dealing with the interpretation of treaties was established as one of its primary purposes. See United Nations, supra note 579, at pp.51-53.

582 As expressed in Art.1(1) of the Statute of the ILC, the work of the ILC was directed at the promotion of the progressive development of international law and its codification.

583 YBILC 1964-II, at p.200, para.6.

584 The rules needed to be clarified: "there is hardly a branch of the law of treaties which is free from doubt and, in some cases, from confusion", see United Nations, supra note 579, at p.53.

585 As was stated: "They are, for the most part, principles of logic and good sense valuable only as guides to assist in appreciating the meaning which the parties may have intended to attach to the expressions that they employed in a document", see YBILC 1964-II, at p.200, para.5.

586 YBILC 1964-II, at p.200, para.5.

587 For a complete and very detailed analysis of these rules and the manner in which they inform the interpretation of tax treaties see the work of Frank Engelen, supra note 448.

588 Art.31 of the VCLT.

589 YBILC 1966-II, at p.221, para.12.

590 Unless they have a special meaning, see Art31(4) VCLT.

591 Explanation extracted from the Commentaries of Art. 27 VCLT (current Art.31), see UNCLT-I, at p.39; and also YBILC 1966-I(II), at p.267, para.96.

The unitary character of the rule is reinforced by its history[592]. At a certain point in time, after carefully analysing a draft rule that contained an enumeration of the different elements of interpretation[593], the proposal was ignored as it suggested that there was some sort of hierarchy amongst the elements[594]. Instead, the current drafting of Art.31 VCLT was chosen by the ILC precisely because it corroborates that the different elements are placed on an equal footing[595]. Furthermore, it was decided that the rule should be titled in a certain manner so as to stress the fact that none of the elements was to be preferred over the others:

> ' […] article 27 [actual Article 31 VCLT] is entitled "General *rule* of interpretation" in the singular, not "General *rules*" in the plural, because the Commission desired to emphasize that the process of interpretation is a unity and that the provisions of the article form a single, closely integrated rule'[596].

Consequently, when attributing a meaning to the term 'liable to tax', "one should apply that meaning […] which appears from the text of the treaty when read in good faith in conjunction with all the other elements of interpretation to be taken into account under Article 31 VCLT"[597], using an "integration approach"[598]. This essentially means that no element used by the OECD to describe the expression should be left unattended, and thus its interpretation requires the effort of integrating them all.

9.4.3. The principle of good faith in defining 'liable to tax'

9.4.3.1. Introduction: Good faith and the interpretation of 'liable to tax'

The principle of good faith is a fundamental guiding principle in the field of tax treaty interpretation, which operates without doubt as a legal principle[599]. Its highly moralising character seems to be of particular importance in the field of treaty abuse and double non-taxation. In fact, it has been argued that the application of tax treaties in those scenarios could constitute a breach of the principle of good faith[600]. The term 'liable to tax' has nonetheless been interpreted to accept the application of the OECD MC in some of those cases, which raises the question as to the manner in which the principle tempers the application of treaties. In other words, considering that some States have accepted the application of treaties in scenarios of perceived abuse or non-taxation, this suggests that the way of assigning its meaning to the term

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592 YBILC 1966-I(II), at p.195, para.27 and, in general, at pp.196-198.

593 In fact it was changed from an enumeration of elements to this formula to avoid the criticisms in relation to the rule imposing a hierarchy of elements, see YBILC 1966-II, at p.300, para.16(d).

594 YBILC 1966-II, at p.95, para.4.

595 Despite the presence of a list of elements of interpretation, "[t]he enumeration of those means did not imply any order of legal precedence", nor any "hierarchical order", see YBILC 1966-I(II), at p.196, para.40, and at p.195, para.27, respectively.

596 YBILC 1966-II, at p.219, para.8.

597 Engelen, supra note 448, at p.111.

598 Engelen, supra note 448, at p.121, takes the notion from S. Torres Bernárdez, 'Interpretation of treaties by the International Court of Justice following the adoption of the 1969 Vienna Convention on the Law of Treaties', in G. Hafner et al., (Eds.), *Liber Amicorum Professor Seidl-Hohenvelder – in honour of his 80th birthday*, (The Hague: Kluwer, 1998), at pp.744-748.

599 YBILC 1964-II, at p.200, para.6; YBILC 1964-II, at p.200, para.5; Engelen, supra note 498, at p.123.

600 The OECD has attempted to introduce this concern by including Sec.9.3 and 9.4 of the Commentaries to Art.1 OECD MC. Engelen as in fact argued that "it would indeed be unreasonable and unfair in certain situations if contracting States could require each other to perform the treaty also in cases where the conditions laid down for obtaining the benefits from the treaty are created by means of wholly artificial arrangements", see Engelen, F., *On Values and Norms: The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular*, (London: Kluwer, 2006), at p.36. This idea has found partial acceptance in van Weeghel, Stef, and Gunn, Anna, 'A General Anti-Abuse Principle of International Law', in Maisto, G., et al. (eds.), *Essays on Tax Treaties: A Tribute to David A. Ward*, (Amsterdam: IBFD, 2012), at pp.322-323.

'liable to tax' in good faith is rather unclear and needs to be examined. This is the purpose of the subsequent paragraphs.

9.4.3.2. Pacta sunt servanda

The principle of good faith "flows directly from the rule *pacta sunt servanda*"[601] and it plays a fundamental role in all the different stages of the life of a tax treaty. It appears at their origin, where each party during the negotiation process is "responsible for the consequences of its acts of bad faith"[602]. After the agreement has been concluded, it implies a "sincere and honest desire, as evidenced by a genuine effort, to fulfill the substance of the mutual agreement"[603].

The principle of good faith requires a certain attitude towards the agreement, which exceeds the literality of what has been agreed. In fact, "it is not sufficient that a treaty is performed strictly according to its letter. The principle of good faith rather requires that a treaty is performed according to its spirit and in an honest, fair and reasonable manner"[604]. In essence, when interpreting the term 'liable to tax' to give access to treaty benefits, it is "the spirit of the treaty that has to be respected"[605].

9.4.3.3. Tax liability and abuse of rights

The principle of good faith also implies that "no right granted by treaty may be exercised arbitrarily or maliciously solely for the purpose of causing injury to another"[606]. Abuse of rights is thus a branch of good faith that is of high importance in setting up boundaries to the parties[607]. When assigning its meaning to the term 'liable to tax', this principle "prohibits a party from exacting from the other party advantages which go beyond their common and reasonable intention at the time of the conclusion of the treaty"[608].

In essence, the principle of abuse of rights draws the "line dividing the right from the obligation, or, in other words, the line delimiting the rights of both parties [...] to a point where there is a reasonable balance between the conflicting interests involved"[609]. An abusive interpretation of treaties surpasses the natural extension of the rights conferred by the agreement to the parties and, in that sense, a breach of good faith results in a breach of the treaty itself[610]. By way of illustration, State A and State B have entered into a treaty based on the OECD MC and, under Art.23 of that treaty, State A is obliged to grant an exemption. After a few years of peaceful application of the A-B treaty, State B starts denying the application of the reduced rates of withholding tax in State B, based on the absence of taxation in State A. According to State B, the application of the treaty by State A undermines its situation (for instance because it causes non-taxation). Bearing in mind that State B knew that State A would grant a full exemption at the time

601 YBILC 1966-II, at p.221, para.12.
602 Cheng, Bin, *General Principles of Law as Applied by International Courts and Tribunals*, (Cambridge: Cambridge University Press, 1953), at p.117-118.
603 Cheng, supra note 602, at p.118.
604 Engelen, supra note 448, at p.125.
605 Cheng, supra note 602, at p.117.
606 Engelen, supra note 448, at p.127.
607 States must interpret treaties "without taking advantage of the fact that they usually have to interpret their own obligations", see van der Bruggen, Edwing, 'Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties', 43 *European Taxation* 5 (2003), at p.145.
608 Cheng, supra note 602, at p.118.
609 Cheng, supra note 602, at p.132.
610 Vogel, supra note 6, n.125b, at p.66.

the treaty was concluded, State B should not be allowed to argue that the application of the treaty is abusive, particularly if State A is merely fulfilling its obligation to provide an exemption under the treaty.

One may also try to look at this principle from the perspective of the treaty claimant. In general, it has been said that the principle of abuse of rights focuses primarily on the parties of a tax treaty, namely the contracting States, and not on the person invoking its provisions[611]. As a result of this, one should not test whether the use of a treaty by a particular person may be qualified as abusive. However, the presence of abuse seems to be of particular relevance from the perspective of the subject entitled to treaty benefits. It is the treaty claimant who, more often than not, manipulates the interpretation of the term 'liable to tax' in order to secure the benefits of the agreement[612], even if that interpretation trespasses the line of abuse. In cases of treaty shopping, for instance, the question is commonly raised as to whether the State in which treaty benefits are claimed must uphold that claim (thereby granting the benefits of the treaty), or is to reject it, so as not to support the alleged abuse of its provisions.

It is hardly deniable that the standard of conduct imposed by good faith, although not directly aimed at the treaty claimant, bears consequences from the perspective of the States parties to the agreement. While "[t]he function of good faith in this respect is thus to temper the state's discretion"[613] to exercise its obligations, the heart of this duty lies in the faculty of supporting or rejecting abusive treaty claims raised by particular persons. In other words, even if one assumes that the principle of abuse of rights does not apply directly to the treaty claimant, by imposing a duty not to support claims that are questionable from the perspective of abuse, the principle of good faith indirectly sets out standards to define terms such as 'liable to tax' in the context of the Model.

The question nonetheless remains as to the conceptualisation of abuse from the perspective of good faith, inasmuch as the rights and obligations of the parties are given by the specific terms of the agreement they have entered into. In other words, the process of interpretation of tax treaties is not to be carried on in the abstract, but considering the terms of the agreement reached by the parties. This implies that an abuse will never occur in the abstract, but it will only occur in relation to the provisions of the particular treaty. When entering into a tax convention, the parties converge in the idea of setting up a variety of policy considerations. Logic indicates that, having the parties consented, the standard of conduct imposed by the principle of abuse of rights refers precisely to those considerations[614]. If, in the example above, State A incentivises foreign direct investment by way of allowing treaty shopping, and State B knew this during the negotiation process, then the occurrence of treaty shopping in State A cannot be characterised as abusive by State B without severe reservations.

9.4.3.4. The principle of effectiveness in defining 'liable to tax'

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611 Van Weeghel, supra note 133, at p.116. Van Weeghel and Gunn notice that, unlike other treaties, the aim of tax treaties is "*not* to grant rights to an individual as such. Instead, the crux of the approach in tax treaties is the allocation of taxation rights between the two contracting States", see van Weeghel, supra note 600, at p.306; Maisto G., 'Domestic Anti-Abuse Rules and Bilateral Tax Conventions in the Light of Public International Law', in Maisto, G., et al. (eds.), *Essays on Tax Treaties: A Tribute to David A. Ward*, (Amsterdam: IBFD, 2012), at p.339.

612 "Tax treaties are addressed to [...] both governments and to the taxpayers of both countries" Arnold, Brian, and MacIntyre, Michael, *International Tax Primer*, 2nd Ed., (The Hague: Kluwer, 2002), at p.112. Vogel, supra note 6, n.15, at p.87, clarifies that the duties and rights derived from a treaty become available to persons only to the extent that the treaty becomes applicable at the internal level.

613 Van der Bruggen, supra note 607, at p.145.

614 Thus abuse must be checked on a case-by-case basis, see Resch, supra note 470, at p.483.

The principle of effectiveness, also derived from good faith, comprises two different rules. Firstly, good faith "requires that a treaty be interpreted in such a way that all of its provisions have some meaning"[615]. Secondly, good faith also implies that the intention of the parties, when expressed in written form, needs to be enforced[616]. As a guiding principle, the ILC considered that effectiveness was too evident to be expressly included in the general rule of interpretation, because there was no reason to look for the meaning of words if not to give it effect[617]. According to the rule *ut res magis valeat quam pereat*, the treaty "as a whole must be taken to have been concluded to achieve some intended effect"[618].

Considering the role the term 'liable to tax' plays in the sphere of tax treaties, it must be emphasised that its interpretation should not only result in the production of effects from the perspective of the term itself but, more generally, it should be construed so as to promote the effectiveness of the treaty as a whole. The term 'liable to tax' needs to be interpreted so as to recognise its "fullest weight and effect consistent with the normal sense of the words and with other parts of the text."[619] This, however, does not imply that under an interpretation of the term 'liable to tax' the rules of the treaty must necessarily produce an effect[620], but only if it is clear that the parties so intended. By way of illustration, the term 'liable to tax' should not be attributed a meaning equivalent to that of the word 'taxed' under the argument that the Model needs to avoid double taxation (except of course if the parties have so agreed). The treaty must be interpreted in a way in which the term has some meaning, but the extent of that meaning will depend on the agreement of the parties. Before defining 'liable to tax' as 'taxed', one should therefore first conclude, on the basis of the treaty itself, that the purpose of the agreement is limited to the avoidance of double taxation, and that there would be no purpose in applying its rules if it is not to achieve that goal.

9.4.3.5. The intention of the parties and the boundaries to good faith

Even if the principle of good faith seems to be quite abstract, in the sense of setting out some sort of standard of behaviour that may be applicable in general, the interpretation of treaty terms is normally carried on in a rather concrete situation, which is the application of a particular tax treaty[621].

Good faith derives from the principle of *pacta sunt servanda*, and this principle implies that the commitments acquired by the parties must be satisfied in the manner in which they intended to set them up. Hence, it does not seem that the presence of abuse can simply be derived from the existence of a morally questionable behaviour, but it must certainly be based on violation of the duties consented by the parties in the treaty. That being the case, it seems reasonable to conclude that the intention of the parties plays quite a significant role for the purposes of setting up boundaries for the definition of 'liable to tax' in good faith. In other words, not implying that good faith in itself has a relative meaning, it is rather evident that, when a treaty is to be applied, the behaviour of the parties should not be tested in the abstract, but precisely against the framework of what they have agreed.

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615 Engelen, supra note 448, at p.133.
616 Cheng, supra note 602, at p.116.
617 YBILC 1964-II, at p.201, para.8.
618 Van der Bruggen, supra note 607, at p.146.
619 Sir G. Fitzmaurice's formulation of the principle of effectiveness, in YBILC 1964-II, at p.55.
620 So as to always avoid double taxation or prevent evasion, see Engelen, supra note 448, at p.429.
621 Engelen, supra note 448, at p.131.

The motivations behind the conclusion of a tax treaty are therefore fundamental when assigning a common meaning to its terms. As was stated earlier, the States will enter into a tax treaty with the view of implementing several policy objectives they find valuable given their domestic circumstances. Those reasons determine what the parties have committed themselves to do, and the specific form in which those promises are supposed to be given effect to. It would indeed not be reasonable to ignore the intention of the parties[622] as a guideline to ascertain the meaning of a term in good faith, specially one such as 'liable to tax', which, given its function, allows the application of all those policy decisions. It is fair to wonder, nonetheless, the extent to which that intention must be considered.

After carefully analysing this, the ILC[623] concluded that the extent to which the intention of the parties would play a role in the interpretation process would be limited by the particular terms of the agreement[624]. If the subjective element was supposed to be relevant for the purposes of interpreting a treaty[625], then the source from where it may be extracted had to be strongly circumscribed: "where this common intention has been reduced to writing, it is primarily the common intention as set out in the text which is to be enforced"[626]. It was convenient "to refer to the text than to the intention or will of the parties as the source of the legal rule. For the rule was the expression for the will, and that expression was to be found in the text."[627] A fair, honest, and reasonable interpretation of the term 'liable to tax' would not only permit but also encourage the assumption that the intention of each contracting State has found its way into the text of the agreement. The meaning of the term is thus detached from what the parties had in mind or, perhaps more importantly, from what they may claim to have had in mind during the negotiation process.

To good faith "the elucidation of the meaning of the text rather than an investigation *ab initio* of the supposed intentions of the parties constitutes the object of interpretation"[628], and therefore "it is not the function of interpretation to revise treaties or to read into them what they do not, expressly or by implication, contain"[629]. The parties are "to be presumed to have that intention which appears from the ordinary meaning of the terms used by them"[630] and, consequently, it is the intention that arises from the words that needs to be found[631].

9.4.3.6. Evaluation: 'Liable to tax' in the light of good faith

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622 YBILC 1966-II, at p.211.
623 YBILC 1966-II, at pp.220-223.
624 After analysing the position of the International Court of Justice on the matter, Engelen concludes: "The objectively established intention of the parties, not their subjective intention, is of importance. Even if it could be demonstrated that their subjective intention was to create a political understanding, and not to create a legally binding agreement, no departure would be allowed from the parties' intention as established objectively on the basis of the contents of the agreement", see Engelen, supra note 448, at p.24.
625 Cheng, supra note 602, at p.117.
626 Cheng, supra note 602, at p.116.
627 YBILC 1966-I(II), at p.197, para.50.
628 YBILC 1966-II, at p.223, para.18.
629 YBILC 1966-II, at pp.220-221, para.11.
630 YBILC 1966-II, at p.221, para.12.
631 The intention of the parties, insofar as it remains in the minds of the drafters would play, if any, a very restricted role as a supplementary means of interpretation, see Article 32 VCLT.

It is on the basis of good faith, understood "as an objective criterion in the light of the particular circumstances, not good faith as an abstract notion"[632], that the interpretation of the term 'liable to tax' must be carried on in a fair, reasonable and honest manner. This interpretation needs to look for the intention of the parties in using such an expression on the basis of what they have expressed in the text of their agreement. The interpretation of this term cannot do violence to other parts of the treaty nor to the objects and purposes pursued by it[633]. On the contrary, instead of defeating that purpose, the meaning assigned to the expression must reinforce it. By way of illustration, if the parties agreed on the fact that the granting of treaty benefits was not subject to effective taxation in any of the contracting States, then in good faith the term 'liable to tax' cannot be defined as 'taxed'.

At the same time, the interpretation of the term 'liable to tax' must recognise, if possible, effects to the expression itself and, given the role it plays, to help other rules of the agreement to have an effect as well. This, however, cannot imply that the term 'liable to tax' needs to be defined as 'taxed' only because otherwise the treaty will not produce an effect. If it is clear from the wording of the treaty that the parties decided to enter into an agreement for the avoidance of double taxation only, then the term 'liable to tax' may be defined as 'taxed'. If, on the contrary, the parties concluded an agreement for the allocation of tax jurisdiction, then the term 'liable to tax' would be attributed a meaning in good faith even if the treaty is not used to avoid actual double taxation.

Moreover, the meaning of 'liable to tax' in good faith should not be structured to generate or facilitate abuse. The presence of abuse, however, is strongly connected with the specific terms of the agreement. Whether the parties have in fact abused a treaty or not is something that cannot be tested in the abstract but, on the contrary, it must be verified in the light of the terms of the agreement negotiated by the parties. As was stated before, if a State accepts the occurrence of treaty shopping to promote foreign direct investment, and that circumstance was known to its counterparty when negotiating a treaty, this should have an impact when determining the boundaries of abuse in that particular treaty. An entity pursuing a strategy of treaty shopping in that State could, in good faith, be classified as 'liable to tax' according to the definition of residence of that particular treaty.

It must be emphasised, therefore, that whether tax treaties and particularly the term 'liable to tax' are being interpreted in good faith or not is always a concrete concern that depends fundamentally on the terms of the treaty in which the expression is used. This occurs because "[t]reaties are to be interpreted primarily as they stand, and on the basis of their actual texts."[634]

9.4.4. The ordinary meaning of 'liable to tax'

9.4.4.1. Introduction

Inasmuch as the text of a treaty is fundamental in order to unravel the intention of the parties, the meaning of the words used in a treaty is crucial for an elucidation of such intention. According to Article 31 VCLT, treaty terms may have an ordinary or a special meaning. The VLCT operates on the assumption that the expressions contained in a treaty are interpreted according to their ordinary meaning. Only if it is established a special meaning was used to define a term then such a

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632 Sinclair, Ian, *The Vienna Convention on the Law of Treaties*, (2nd ed.), (Manchester: Manchester University Press, 1984), at p.120.
633 Engelen, supra note 448, at p.34.
634 YBILC 1964-II, at p.55, para.12.

meaning must prevail[635]. In the case of the term 'liable to tax', as has been stated earlier, the history of the Model suggests that there was nothing special in the use of this expression, beyond the need to refer to the cases of residence under the laws of the majority of the States[636].

9.4.4.2. Ascertaining the *ordinary* meaning of 'liable to tax'

While it is clear that the expression 'liable to tax' may have several meanings, it seems that the VCLT does not refer to all of them. This is of particular relevance considering the function performed by the term 'liable to tax' which, if interpreted differently, may lead to contradictory conclusions in relation to the need of applying a tax treaty. The use the expression 'ordinary meaning'[637] resulted from the need to stress the fact that the meaning of a term under the VCLT was not any meaning, but only one consistent with the context in which the term was used[638]. Hence, the ordinary meaning of 'liable to tax' in the context of the OECD MC "is not necessarily that of everyday use"[639], and therefore it "does not necessarily result from a pure grammatical analysis of the text of the treaty"[640]. As a matter of fact, 'nothing could have been further from the [ILC]'s intention than to suggest that words had a "dictionary" or intrinsic meaning in themselves'[641].

Despite the fact that it may be a very confusing notion[642], the *ordinary meaning* of a treaty term is given by the use of the expression in a certain context, in attention to the intention of the parties[643], and in the light of the terms used by them to express their will. In that sense, the text of the agreement, in this case, the OECD MC, is the primary source from where the ordinary meaning of the term 'liable to tax'[644] must be extracted[645].

9.4.4.3. Evaluation: Good faith and the textual approach to the meaning of 'liable to tax'

As has been stated earlier, the intention of the parties is relevant when attributing its meaning to a treaty term, because as the policy objectives they pursue may affect that meaning according to their subjective intention. However, insofar as good faith implies that the extent of such intention is restricted by the terms they use, it would not make sense if a meaning were attributed to the term 'liable to tax' according to the sole subjective intention of the parties. On the contrary, "the parties are to be presumed to have that intention which appears from the ordinary meaning of the terms used by them"[646]. The drafters of the VCLT considered that, more than any other thing, it

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635 Art. 31.4 of the VCLT; Vogel, supra note 6, n.69a, at p.37.
636 See FC/WP2(56)1, at pp.1-2.
637 After having used 'natural and ordinary meaning' in YBILC 1964-II, at p.52, and 'normal, natural, and unstrained meaning' in YBILC 1964-II, at p.55, para.12, the ILC finally adopted for 'ordinary meaning' in YBILC 1964-II, at p.199, para.12.
638 Wattel, P., and Marres, O., 'The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties', 43 *European Taxation* 7 (2003), at p.226.
639 Vogel, supra note 6, n.70, at p.37.
640 Engelen, supra note 448, at pp.145-146.
641 Commentaries of Article 27 VCLT (actual Article 31). See United Nations, *Conference on the Law of Treaties, First session Vienna, 26 March-24 May 1968 Official Records*, (1968), at p.184.
642 The determination of that sense was assumed to be "not so straightforward as it would appear at first sight", see YBILC 1966-II, at p.336.
643 YBILC 1966-I, at p.192, para.88.
644 It was admitted that a meaning could be attributed to phrases, YBILC 1964-II, at p.55, para.12.
645 There is in fact some sort of presumption that all the elements to define the term 'liable to tax' will be found in the OECD MC, for the expression 'ordinary meaning' is used as "an attempt to describe texts which do not require any reference to other sources for the purpose of defining their meaning", see YBILC 1966-II, at p.336.
646 YBILC 1966-II, at p.221, para.12.

was important to discover the meaning of a term in its context, regardless of "the psychological intention of the authors"[647].

A treaty term cannot be assigned any meaning, but only one that arises from the terms of the treaty integrally. This is the reason why Article 31(1) VCLT does not refer to the need of *finding* the ordinary meaning of a treaty term but, on the contrary, under the rule its meaning shall be *given* to those terms, as if the terms were a mirror of the different parts of the agreement in which they are used. The attribution of its ordinary meaning to the term 'liable to tax' in good faith must lead to a reasonable, honest, expectable effect in relation to the use of the term, to avoid an interpretation of the Model which, in the light of the intention of the parties duly portrayed in the text of the treaty, would be absurd or unreasonable.

9.4.5. Ordinary meaning of 'liable to tax' in its context

9.4.5.1. Context for a definition of 'liable to tax'

The ordinary meaning of a treaty term is not to be found in a dictionary but in the context of the agreement in which it is used. Words cannot be divorced from its context[648]. In fact, "there is no such thing as an abstract ordinary meaning of a phrase, divorced from the place which that phrase occupies in the text to be interpreted"[649]. This was the opinion followed by the ILC[650]: "a term in isolation had no meaning; terms had no meaning except in a sentence or in a set of sentences and articles, in other words, in their context"[651]. In other words, "a term could only be understood in a sentence, a sentence only in an article, and an article only in the treaty as a whole"[652]. Likewise, "the concept of ordinary meaning would essentially be a fiction unless that ordinary meaning could be gleaned from the circumstances surrounding the conclusion of the treaty"[653]. If two interpretations of a treaty term are possible, one that considers the context and one that ignores it, the former must always prevail[654].

While the VCLT explains in detail the instruments that may be regarded as context[655] for the purposes of treaty interpretation, it is somewhat clear that in determining the significance of the term 'liable to tax' the OECD MC "is of primary importance, [...] and the wording not of the individual provision, but that of the entire agreement in context"[656] is in fact relevant. The attribution of its ordinary meaning to the term 'liable to tax' in good faith requires to fit the term

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647 YBILC 1966-I(II), at p.201, para.41.
648 UNCLT-I, at p.171, para.70.
649 See Sinclair, supra note 632, at p.121.
650 At a certain point in time, in fact, a proposal was made of a rule enumerating ordinary meaning, context and object and purpose. The proposal was rejected inasmuch as it appeared that the rule had been built on the basis of an ordinary meaning that was independent from the context, see YBILC 1966-II, at p.95, para.5.
651 YBILC 1966-I(II), at p.189, para.57.
652 YBILC 1966-I, at p.197, para.51.
653 UNCLT-I, at p.183, para.58.
654 YBILC 1966-I, at p.194, para.21.
655 According to Article 31.2 VCLT, the context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. Moreover, the rule suggests that there shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties.
656 Vogel supra note 6, n.69, at p.37.

into the system, regardless of the apparent inconsistencies in relation to the Model and its interpretation. Further, the ordinary meaning of 'liable to tax' does not only need to fit into the agreement as a whole, but it must also not do violence to the rest of the terms of the treaty. The meaning attributed to the term should also provide effectiveness to all the other parts of the agreement, except only when such an interpretation is simply not possible.

9.4.5.2. The Commentaries to the Model as an element of context

In determining what 'context' means for the purposes of the rules of interpretation, Article 31(2) VCLT refers, in very simplified terms, to agreements between the parties or instruments made by one or more parties but accepted by the others, related to the conclusion of the treaty. Moreover, Article 31(3) VCLT includes a mention to certain agreements or practices in relation to the interpretation of the treaty and any relevant rules of international law applicable to the relations between the parties. When interpreting a treaty, these elements are to be included *together*[657] with the context.

By referring mostly to agreements in relation to which the consent of both parties has been manifested, it is rather doubtful whether the Commentaries to the OECD MC could form part of the context in which the agreement must be interpreted[658]. Scholars are in fact divided in this regard. Vogel, to whom the Commentaries were originally considered as context[659], was later of the opinion that the constant modifications to the Model and particularly the adoption of a loose-leaf format by the OECD had dropped their value significantly[660]. Engelen has recognised the same contextual value and thus a legally binding character in some cases[661]. Avery Jones[662] and Wattel and Marres[663] agree with the consideration of the Commentaries as a contextual element. Ault[664], Arnolds and McIntyre[665], on the other hand, attribute only a supplementary character to the Commentaries.

Regardless of the opinion one may have about the potential binding character of the Commentaries[666], "the issue appears to be of little practical significance. In treaty cases from virtually all countries the courts invariably give the Model Treaty and Commentary substantial

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657 Art. 31.3 VCLT.
658 See YBILC 1966-II, at p.222, para.12.
659 Vogel supra note 6, at pp.45-46. As the Commentaries in some cases where binding, in those cases they could have been considered as part of the text of the treaty according to Article 31(2) VCLT.
660 In reference to the changes introduced from 1992. In his opinion, however, the Commentaries should in any case be considered to be a supplementary means of interpretation, Vogel, Klaus, 'The Influence of the OECD Commentaries on Treaty Interpretation', 54 *Bulletin for International Taxation* 12 (2000), at p.616.
661 Engelen, Frank, 'Some Observations on the Legal Status of the Commentaries on the OECD Model', 60 *Bulletin for International Taxation* 3 (2006), at p.109.
662 Given the fact that the parties can introduce observations to the Commentaries, if they do not, they presumably agree with it. In the worst case, the Commentaries may be used as a supplementary means of interpretation, see Avery Jones, John F., 'The Effect of Changes in the OECD Commentaries after a Treaty is concluded', 56 *Bulletin for International Taxation* 3 (2002), at pp.102-104.
663 Wattel et al., supra note 638, at p.226.
664 Ault, Hugh, 'The Role of the Commentaries in the Interpretation of Tax Treaties', 22 *Intertax* 4 (1994), at p.148.
665 Arnold, supra note 612, at pp.113-114.
666 On the relation between the OECD MC and the potential binding character of the Commentaries, along with the interpretative value of the latter, see Vogel, supra note 660, at pp.612-616; Engelen, supra note 661, at pp.105-109; Pijl, Hans, 'The OECD Commentary as a Source of International Law and the Role of the Judiciary', 46 *European Taxation* 5 (2006), at pp.216-224; Erasmus-Koen, Monica and Douma, Sjoerd, 'Legal Status of the OECD Commentaries: In Search of the Holy Grail of International Tax Law', 61 *Bulletin for International Taxation* 8 (2007), at pp.339-352.

weight"[667]. Even if they are considered to have a lower value[668], "the interpretative process is a unity and all the various elements and means of interpretation that are present in any given case may be consulted simultaneously"[669]. Bearing in mind that the Commentaries contain the official interpretation of the Model by the OECD, and that most of the issues in interpreting tax treaties derive from these elements, it is rather evident that an attempt should be at least made to take them into consideration when attributing the term 'liable to tax' its ordinary meaning.

9.4.5.3. Assigning its ordinary meaning to 'liable to tax' in the context of the Model

Context is in fact a puzzling element to apply when trying to ascertain the ordinary meaning of 'liable to tax', and perhaps this is the reason why in some cases it seems to be ignored. As has been explained in previous parts of this study, an inconsistent practice throughout the Model and its Commentaries in explaining the different dimensions of the subject entitled to treaty benefits create obstacles to elucidate, with a fair degree of certainty, the cases in which the Model applies.

Amongst the elements of context for the definition of 'liable to tax', the second sentence of Art.4(1) OECD MC is the most noticeable. This rule plays a crucial role in explaining what the ordinary meaning of 'liable to tax' in the context of the Model is[670]. While in principle it was supposed to perform a very particular function, later interpretations by the OECD have sought to expand the rule and embed an anti-avoidance principle into it[671]. By doing so, the OECD has restricted the application of tax treaties to a point in which stating that the Model seeks to impose no standards for domestic residents to access its benefits seems incorrect.

The OECD has also provided abundant material on the ordinary meaning of 'liable to tax' when explaining the need of effective taxation for the purposes of treaty access[672]; the treaty entitlement of transparent entities and bodies of persons[673]; treaty access by persons who are residents of States applying the territorial principle[674]; the connecting criteria mentioned in Art.4 OECD MC[675]; and many other elements previously examined. Moreover, as has been stated earlier, the history of several provisions of the Model is filled with elements explaining the different dimensions of the subject entitled to tax treaties[676].

The Commentaries to the Model pose quite a significant challenge when attributing the term 'liable to tax' its ordinary meaning in good faith, for the rules in it are, at least apparently, quite inconsistent. While they seem to exclude persons that are liable to tax only on income from sources in a State[677], they seek not to exclude residents of States applying a territorial system of

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667 Arnold, supra note 612, at p.114; Heinrich, J., and Moritz, H., 'Interpretation of Tax Treaties', in 40 *European Taxation* 4 (2000), at p.148; Broekhuijsen, Dirk M., 'A Modern Understanding of Article 31(3)(c) of the Vienna Convention (1969): A New Haunt for the Commentaries to the OECD Model?', in 9 *Bulletin for International Taxation* 3 (2013), at section 4.

668 For instance when they are considered to be supplementary means of interpretation of Article 32(4) VCLT.

669 Engelen, supra note 448, at p.329.

670 This issue is examined in detail in Chapter 7 and Chapter 10.

671 The rule was supposed to deal with the situation of diplomats only, and its scope was later broadened, see Chapter 7, at pp.84ff.

672 This was examined in detail in Chapter 8.

673 This aspect of the definition is analysed in Chapter 4.

674 The situation of residents of States applying the territorial principle is touched upon in Chapter 5, at pp.60ff; and in Chapter 7, at pp.91ff.

675 The connecting criteria are analysed in Chapter 5.

676 This occurs in the case of the rules of relief, Art.1, Art.10, Art.20, Art.21 OECD MC, amongst others.

677 Sec. 8.2 of Comm. to Art.4 OECD Model Convention (2014).

taxation[678]. While they recognise the tax liability of a tax-exempt person in some cases[679], it acknowledges that some States do not accept that conclusion[680]. This however, occurs because of a fundamental feature of the OECD MC, which is precisely the fact that has been designed as a *model convention*, to harmonise[681] tax treaties and, accordingly, to fit the needs of countries which tax systems and policy interests have notable differences.

While the purpose of the OECD MC has been fulfilled in the sense that its use is now widespread[682], at times it is rather doubtful whether the interpretation promoted by the OECD in the Commentaries is of much assistance when attributing its ordinary meaning to 'liable to tax'. In any case, if a State decides to use the nomenclature of the OECD MC as such, following at the same time the interpretations of the OECD contained in the Commentaries, an effort must be made to reconcile the different elements of context that inform the meaning of 'liable to tax' so as to recognise effect, where possible, to all of them.

According to what has been explained in different parts of this study, it must be borne in mind that the context in which the term 'liable to tax' has been used, that is to say, the Model and its Commentaries, describe a meaning which is allegedly different than that of residence at the domestic level. While originally the OECD did not even intend to define residence[683], today the meaning of the expression has been so extensively described that it is almost impossible to sustain that no standards are imposed by the Model to access its benefits. Furthermore, one cannot forget that irrespective of the fact that the term 'liable to tax' must be assigned a meaning in the context of the OECD MC, the text in which the expression is used does not suffice for an illustration of its ordinary meaning. According to the VCLT, attention must also be paid to the treaty's object and purpose[684].

9.4.6. Ordinary meaning of 'liable to tax' in the light of the OECD MC's object and purpose

9.4.6.1. Introduction: The crossroads in the application of tax treaties

One of the major problems in the world of tax treaties derives from the interpretation of the term 'liable to tax' on the basis of the choice made as to the object and purpose of the OECD MC. Under the current literature on tax treaties, deciding that the Model aims at the avoidance of double taxation seems to carry the need to define the term 'liable to tax' as 'taxed'[685], whereas if the allocation of tax jurisdiction is found to be the OECD MC's underlying purpose, the result is essentially different[686]. From the perspective of assigning its ordinary meaning to the term 'liable to tax', this entanglement imposes the need to face the crossroads, in the sense that the election takes to the production of quite an inconsistent outcome.

Further, some of those who argue that the OECD MC seeks primarily to avoid double taxation have gone one step further and suggested that under such an approach, the application of the Model in

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678 Sec. 8.3 of Comm. to Art.4 OECD Model Convention (2014).
679 Sec. 8.6 of Comm. to Art.4 OECD Model Convention (2014).
680 Sec. 8.7 of Comm. to Art.4 OECD Model Convention (2014).
681 Sec.2 of the Introduction to the Comm. to the OECD Model Convention (2014).
682 There are over 3000 treaties based on OECD MC.
683 For an historical overview of the definition of residence, see supra, Chapter 2.
684 See Art.31 VCLT.
685 It has been stated that in the view of the object of the treaty "what matters is not the existence of a liability but a crystallisation of that liability by payment", see *Sportsman*, supra note 23, at para.6.9; see also *Bayfine*, supra note 560, at para.40.
686 *The State of the Late John N. Gladden*, supra note 89, at para.20.

situations of non-taxation should not be endorsed[687]. Hence, the decision in relation to the object and purpose of the OECD MC would not only determine the circumstances in which the Model should be applied but also, and perhaps more importantly, the cases in which its benefits should be denied.

A careful consideration of the issues derived from such an approach, however, raises some fundamental questions. The first one aims at discovering the underlying object and purpose of an agreement such as the OECD MC, beyond the reasons leading to the discussion of tax treaties historically[688]. According to what has been stated so far, to ignore the words of the Model does not seem to be compatible with an interpretation of treaties in good faith. Secondly, while it is undeniable that the avoidance of double taxation forms part of the scope of issues covered by the Model, the fact that it also carries the need to avoid double non-taxation is highly uncertain. The application of treaties in scenarios of double non-taxation has been endorsed even by the OECD[689], and this has occurred in the sphere of a model convention which, according to mainstream literature, aims at the avoidance of double taxation. The question therefore arises as to the possibility of qualifying the occurrence of double non-taxation in the sphere of treaties as absurd[690]. From the standpoint of the treaty's object and purpose, this would be the only possible manner to argue that such an interpretation of treaties is in open breach of good faith.

Where the conflict has traditionally been reduced to the presence of only two prevalent objects and purposes of the OECD MC between which an election must be made, the question also arises as to the role of all the other purposes the agreement is meant to achieve from the perspective of its interpretation. It would not be coherent with an interpretation of treaties in good faith to suggest that they do not have a value for the purposes of treaty interpretation, particularly in attributing its meaning to the term 'liable to tax', given the function it performs.

9.4.6.2. Object and purpose of the OECD MC: Meaning and source

The object and purpose of a treaty is an element that actively operates in every instance in which a treaty is interpreted. Regardless of the limited value that seemed to derive from the first draft rule in which it was considered by the ILC[691], the final version of the general rule of interpretation was meant to stress the fact that the object and purpose of a treaty was not a secondary element, but rather a fundamental piece in the process of treaty interpretation[692].

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687 Sasseville, Jacques, 'The Role of Tax Treaties in the 21st Century', in 56 *Bulletin for International Taxation* 6 (2002), at p.246; Reimer, Ekkehart, 'Interpretation of Tax Treaties', in 39 *European Taxation* 12 (1999), at p.464.

688 It may be argued that tax treaties should operate only in cases of double taxation because double taxation was the reason to create tax treaties from an historical perspective.

689 In the context of BEPS, the OECD has stated that not every kind of double taxation is harmful: "[n]o or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it", see Action Plan, supra note 27, at p.10. It is thus evident that not every situation of non-taxation is rejected, but only those that arise in connection with strategies of tax avoidance.

690 'The phrase "in the light of the objects and purposes of the treaty" was inserted as an objective criterion in order to discourage disingenuous recourse to the notion of an "absurd" interpretation', see YBILC 1966-I(II), p.206, para.39. See also *Sportsman*, supra note 23, at para.4.2.

691 According to one of the first drafts of the rule, only if the natural and ordinary meaning of a term led to an interpretation which was manifestly absurd or unreasonable, consideration was given to the objects and purposes of the agreement, see YBILC 1964-II, at p.52.

692 YBILC 1964-I, at p.218, para.86-87, the final version of the rule approved at pp.316-317. This is why the word 'and' was used between 'context' and 'object and purpose', see YBILC 1966-I(II), p.269, para.10.

The words 'object and purpose' in Art.31 VCLT form an integral expression[693], which aims at portraying the motivations that conduct the parties to the conclusion of a certain agreement. Provided that the purpose behind a tax treaty is given by the reasons that motivate the parties to negotiate, this aspect undoubtedly carries an element of teleological interpretation. Even in the case of two States that seek to implement an essentially different policy at the domestic level, there must always be a point in which their intention actually coincides[694].

Considering that the interest of the parties is fundamental in shaping their agreement, it is legitimate to wonder whether that intention is the sole source from where the object and purpose of the agreement is to be identified. In the Gladden case, the Court pointed out that "[c]ontrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties"[695]. While this may seem reasonable from the perspective of attributing a certain value to the motivations behind the agreement, such an approach is not entirely faultless from the perspective of good faith.

History indicates that the source of the object and purpose of a treaty was discussed at a stage in which the textual approach on treaty interpretation was so strongly settled, that it was evident that the intention of the parties had to be extracted from its words[696]. According to the ILC, "the objects and purposes of the treaty must be sought first in the text itself"[697], and not in "any extraneous evidence or indications of the intention of the parties"[698]. In fact, the "[i]nvestigation of the circumstances surrounding the conclusion of a treaty should be undertaken in order to determine not the subjective intention of the parties but rather the objective intention expressed by them in the text of the treaty."[699] Inasmuch as the agreement is turned into words, it is that vocabulary that must be taken as a starting point for unravelling its underlying intention: "For the rule was the expression for the will, and that expression was to be found in the text."[700]

This does not mean that the intention of the parties must be ignored[701] in describing the purpose of a tax treaty. On the contrary, it means that the intention of the parties needs to be sought not in their minds but in the text they have agreed upon[702], only to be disregarded if it does not find support in that text[703]. This is perfectly consistent with an interpretation of treaties in good faith, for it would certainly be an act of good faith to assume that the intention of the parties has not been hidden but, on the contrary, it has been captured in the text of the arrangement.

Further, to use the treaty's object and purpose "among the elements to be thrown into the crucible when giving the terms of the treaty their ordinary meaning"[704] presupposes that the terms of a treaty should not be appreciated individually but according to "the entire agreement in

[693] To Vogel "there appears no be no reasonable interpretation of 'object' separate from 'purpose', see Vogel, supra note 6, n.70a, at p.37; the same in Linderfalk, Ulf, *On the Interpretation of Treaties*, (Dordrecht: Springer, 2007), at p.209.

[694] Jacobs has said that "in many cases there will be no common intention", Jacobs, Francis G., 'Varieties of Approach to Treaty Interpretation: With Special Reference to the Draft Convention on the Law of Treaties Before the Vienna Diplomatic Conference', 18 *International and Comparative Law Quarter* (1969), at p.339.

[695] *The State of the Late John N. Gladden*, supra note 89; Van der Bruggen, supra note 607, at p.148.

[696] YBILC 1964-II, at p.52.

[697] YBILC1966-I(II), at p.186, para.14.

[698] Engelen, supra note 448, at p.175; Jacobs, supra note 694, at p.337.

[699] UNCLT-I, at p.183, para.59.

[700] YBILC 1966-I(II), at p.197, para.50.

[701] Reimer, supra note 687, at p.459.

[702] Irrespective of the arguments that may be used to sustain the value of the subjective element, the VCLT is quite clear when using the possessive 'its' to refer to the purpose *of the treaty*, and not of the parties.

[703] Vogel, supra note 6, n.69a, at p.37.

[704] Engelen, supra note 448, at p.173.

context"[705]. There is in fact some sort of circular relation between the elements of interpretation of tax treaties, which basically results from the fact that the rule of interpretation is a unity. The meaning of a treaty term can neither be divorced from its context, nor from the objects and purposes pursued by the agreement[706] and, at the same time, the context of a treaty cannot be detached from its objects and purposes[707]. Context and object and purpose are, at the outset, "two aspects of a single process."[708]

It is worth emphasising that, under the principle of good faith, the object and purpose of a treaty depends primarily on the terms of the agreement, and it is thus closely related to the way in which that instrument is actually drafted[709]. Therefore, the determination of the object and purpose of a tax treaty may vary from treaty to treaty. Nonetheless, the OECD MC being a model, designed to achieve the "desirable harmonization [...] for the benefit of both taxpayers and national administrations"[710] and to provide "a means of settling on a uniform basis the most common problems"[711], it entails a series of objects and purposes defined as valuable by the OECD.

9.4.6.3. The multiple objects and purposes of the OECD MC

Contrary to the commonly accepted view that the OECD MC has a primary object and purpose the election of which determines the interpretation of the term 'liable to tax', tax treaties, in reality, "have no single undiluted object and purpose but a variety of differing and possibly conflicting object and purposes"[712].

In fact, the draft rule at the origin of the current version of Art.31 VCLT for a long period referred to the 'objects and purposes'[713] of a treaty. It is somewhat evident that tax treaties seek a variety of objectives[714], and so does the OECD MC. The avoidance of double taxation, the elimination of obstacles to cross-border trade and investment and the allocation of tax jurisdiction are the most commonly mentioned. There are several others, however, derived from particular provisions of the Model, such as the prevention of avoidance and evasion[715], cooperation between the States[716], taxation on a non-discriminatory basis[717], and many others[718].

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705 Vogel supra note 6, n.69, at p.37.
706 YBILC 1966-I(II), p.189, para.57.
707 YBILC 1966-I(II), p.190, para.69. This is the reason why they used the word 'and' between 'context' and 'object and purpose', see YBILC 1966-I(II), at p.269, para.10.
708 YBILC 1966-I, p.195, para.27.
709 The purpose of a treaty "can only be given effect in so far as this does not do violence to the actual terms of the treaty", see Engelen, supra note 448, at p.173.
710 Sec. 13 of Introduction to the OECD Model Commentaries.
711 Sec. 3 of Introduction to the OECD Model Commentaries.
712 Sinclair, supra note 632, at p.130.
713 Several meetings of the ILC were sustained on the basis of such a formula, such as the 869th meeting, YBILC 1966-I(II), at p.183, para.51; the 870th meeting, ibid, p.185, para.9; and the 875th meeting, ibid, p.217. In the 876th meeting, Mr. Castrén noticed that while Art.67 (current Art.31 VCLT) used 'objects and purposes' in the plural, other rules of the agreement used it in the singular. He proposed the convenience of unifying the text.
714 Reimer, supra note 687, at p.459.
715 Mainly in Arts.26, 9, 11(6) and 12(4) of the OECD Model Convention (2014), and irrespective of the fact that the OECD has tried to introduce it as a general object and purpose behind tax treaties, situation that has been hardly discussed.
716 Articles 25, 26 and 27 of the OECD Model Convention (2014) setting up the duties of mutual agreement, exchange of information and assistance in the collection of taxes.
717 Article 24 of the OECD Model Convention (2014).
718 For other purposes see Sasseville, supra note 687, at p.247.

At a certain point in time, however, a modification was introduced to Art.31 VCLT. Instead of 'objects and purposes' the ILC opted for the singular 'object and purpose' and, regrettably, no explanation was given[719]. It was explained, however, 'that the words "in the light of the object and purpose of the treaty" would to a large extent cover the idea of the context of the treaty as a whole'[720].

According to Jacobs, the change "may have been intended to give greater certainty, on the ground that there was less likely to be controversy on what was the principal object and purpose of a treaty than on which of several possibly conflicting objects and purposes should determine the meaning of a disputed term"[721]. However, the use of the singular in this provision, as Engelen observes, "raises the question of whether or not in determining the ordinary meaning of the terms of a treaty only the principal object and purpose of the treaty may be taken into account or also the objects and purposes of particular parts, chapters, sections or articles of the treaty"[722]. In words of Avery Jones, "[w]hen Article 31(1) of the Vienna Convention refers to its object and purpose, it is referring to the treaty's object and purpose as a whole, rather than the purpose of the particular provision"[723].

These observations seem to imply that there is the need to identify a single predominant purpose underlying the agreement[724] on the basis of which the treaty as a whole must be interpreted, and particularly when attributing its meaning to the term 'liable to tax'. The problem lies in the existence of two alleged objects and purposes, avoidance of double taxation and allocation of tax jurisdiction, which simply point in different directions.

One may attempt to identify the predominant purpose of the agreement, i.e. choosing one over the others. The solution would apply even if, in some cases, the literality of the rules or the intention of the parties must be disregarded. By way of illustration, those who argue that the avoidance of double taxation is the leading purpose of the OECD MC would normally attribute no value to the application of the Model in scenarios of non-taxation. Under this reasoning, the absolute obligation to provide exemption[725] would have to be ignored. This certainly presupposes that one purpose, the *primary* purpose of the agreement, would have the strength to overcome any other purpose of the treaty (such as merely allocating taxing rights), and even to leave multiple sections of the Commentaries without an effect[726]. Such an interpretation would, however, be highly questionable from the perspective of good faith.

The fact that an interpreter may be forced to make a choice in relation to the purpose of the treaty does not seem to be reasonable[727], if the manner in which the parties have structured their agreement is ignored. One needs to understand that, beyond the fact that the ILC decided to use

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719 In the 883 meeting, the formula 'object and purpose' appears in the singular, and no explanation was given for the change, see YBILC 1966-I(II), at p.267, para.90. From the perspective of other rules of the VCLT, in the 876 meeting a discussion was held in relation to the need of unifying the text, which in some parts used the singular and in others the plural, YBILC 1966-I(II), at p.227, para.125 and para.129, a change from plural to singular was made in the case of Art.40 and Art.41 of the VCLT, voted and adopted at the 893 meeting, YBILC 1966-I(II), at p.330, para.54 and para.55, at the proposal of Mr. de Luna and Mr. Waldock.

720 Sir Humphrey Waldock, see YBILC 1966-I(II), at p.328, para.15.

721 Jacobs, supra note 694, at p.337.

722 Engelen, supra note 448, at p.178.

723 Avery Jones, John, 'Interpretation of Double Taxation Conventions', *IFA Cahiers Vol. 78a*, (1993), at p.602.

724 At least in relation to the observations made by Jacobs it has been so understood, see Linderfalk, supra note 693, at p.212; and in the same line van der Bruggen supra note 607, at pp.142-156.

725 Sec.35 of Comm. to Art.23 OECD Model Convention (2014).

726 Sec.3 of Comm. to 21 OECD Model Convention (2014).

727 De Broe, supra note 496, at pp.328-330.

the singular instead of the plural, there is nothing in the election that implies that the multiple purposes contained in the different parts of the agreement should be ignored when attributing its meaning to any expression used in it[728]. On the contrary, a reasonable, fair and honest interpretation of tax treaties must not disregard the different interests confronted by the States during the negotiation process. Good faith requires acknowledging the value and effects of whole of those arrangements, not from an abstract perspective, but precisely on the basis of what the parties have mutually agreed.

Hence, any reference to the 'object and purpose' of a tax treaty in the singular[729] must be understood to be directed to the sum of all the different purposes pursued by its individual rules, arising from the will of the parties materialised in its words. This is the reason why the object and purpose of the agreement, individually considered, should be intrinsically incapable of doing violence to the purpose pursued by the individual rules. If correctly identified, the primary object and purpose of a tax treaty and that of its particular rules will be concluded not to be separate things, but only one, though in many different parts of the same thing.

When attributing its meaning to the term 'liable to tax' one must therefore assume that there is no contradiction between the different purposes pursued by the Model, buy only an interpretation that is incapable of combining the multiple objects pursued by the individual provisions[730]. Even though different objects and purposes in a treaty apparently collide, the interpreter should seek to interpret the relevant provisions harmoniously, in the light of the different objects and purposes of the treaty.

It is thus stated that the change from plural to singular in the history of Art.31 VCLT is insignificant when attributing its meaning to the term 'liable to tax' and, in general, for the purposes of tax treaty interpretation. Instead of opting for the singular, the ILC may have changed the rest of the rules to the plural, and that might have settled this debate. Today, a necessity would exist to attribute a meaning to the term 'liable to tax' on the basis of all the different objects and purposes of the OECD MC. The avoidance of double taxation and the allocation of tax jurisdiction are to be applied in harmony and not by choosing one and ignoring the other. The change to the singular can under no circumstances be used to argue that a certain purpose of an agreement may overcome the others. It only means that a treaty has multiple purposes, all of them grouped in what is generically referred to as the 'object and purpose' of the treaty which, in good faith, may be extracted from its words[731]. This suggests that, in order to assign the term 'liable to tax' its

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728 Engelen supra note 448, at pp.178-179, and Linderfalk, supra note 693, at p.212.

729 Predominant, primary or leading purpose of tax treaties. It is interesting to notice that the OECD has changed the Commentaries to the Model to that effect. Under the text introducing the change: '3. *These are* ~~this is~~ the main purpose*s* of the OECD Model Tax Convention', see OECD, Action 6: 2015 Final Report, supra note 1, at p.92.

730 Engelen follows another path to the same conclusion: the object and purpose of a certain rule of a treaty is considered because that rule forms part of the context in which an expression is interpreted: "[t]o the extent that the object and purpose of a particular article can be inferred from the text of the treaty, they form part of the context and, therefore, should be taken into account, together with the object and purpose of the treaty taken as a whole, in determining the ordinary meaning of the terms used in the article", supra note 448, at pp.178-179.

731 There is an instance in which the drafters of the VCLT explained their motivations for using an expression in the singular and not in the plural. When illustrating the way in which the interpretation elements provided by the rule of Article 31 should interact, the ILC explained that "article 27 [actual Article 31 VCLT] is entitled 'General rule of interpretation' in the singular, not 'General rules' in the plural, because the Commission desired to emphasize that the process of interpretation is a unity and that the provisions of the article form a single, closely integrated rule". If this was the idea of the drafters when deciding to use 'object and purpose' instead of 'objects and purposes', then it should be clear that there is not just one but multiple objects and purposes in a treaty, and that the use of the singular, as in the rule of interpretation, does not ignore the presence of other more limited purposes in the field of the interpretation of tax treaties, see YBILC 1966-II, para.8, at pp.219-220.

ordinary meaning, all the different aims of the treaty should be reconciled precisely on the basis of its terms.

9.4.6.4. Avoidance of double taxation and allocation of tax jurisdiction: Conflicting objects and purposes in giving its ordinary meaning to 'liable to tax'

A reasonable interpretation of the term 'liable to tax' must not do violence to the rest of the Model. Besides, it needs to provide meaningful and peaceful existence to the different parts of the treaty and to the objectives behind those parts.

This implies that the difficulties derived from the interpretation of Art.4 OECD MC must be confronted with the view of attributing its meaning to the expression 'liable to tax' *in the light* of the objects and purposes of the Model, and not on the condition of shedding light onto them. In other words, it cannot be argued that, since the object and purpose of the agreement seems to be confusing, this element of interpretation should be disregarded and a higher value should be attributed to the other elements of Art.31 VCLT. On the contrary, under an interpretation of treaties in good faith, if a conflict exists in relation to the objects and purposes of the treaty, a formula must be sought in order to shed light on the significance of the terms used by the parties according to the purposes they pursue. Only after utterly failing to do so, it might be concluded that the object and purpose of the agreement is incapable of clarifying the meaning of the expressions used in it.

Keeping that in mind, it must first be acknowledged that the OECD MC certainly aims at the avoidance of double taxation[732]. From an historical perspective, the threat of double taxation triggered the consideration of tax treaties to curb that menace, and subsequently the avoidance of double taxation has been crucial in developing the OECD MC. On the other hand, it also true that the OECD MC aims at the allocation of tax jurisdiction "and such allocation often occurs in a context where double taxation is in no way involved"[733]. This conclusion is relevant considering the following statement in the *Sportsman* case:

> "There would be no practical purpose in the prevention of double assessment."[734]

Whether there is a purpose in preventing double assessments from the perspective of the Model alone, the answer seems to be in the affirmative. If that were not the case, there would be no point in restricting the ability of the State of source to tax, even if it is clear that the State of residence will not impose taxation, as has been explained repeatedly before. The fundamental question

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[732] For the idea that "the general aim of tax treaties undisputedly seems to be the avoidance of international double taxation", see Burgstaller, Eva supra note 464, at p.266; Engelen, supra note 448, at p.428; Ault, Hugh, supra note 163, at p.263; Van Weeghel, supra note 133, at p.15; van der Bruggen, supra note 607, at p.148.

[733] Couzin, supra note 20, at p.109. Concurring Vogel, supra note 6, at p.95; Vogel, supra note 25, at p.419; Ward, David, *Access to Tax Treaty Benefits. Research Report Prepared for the Advisory Panel on Canada's System of International Taxation*, (Toronto: Advisory Panel on Canada's System of International Taxation, 2008); to Barthel, "with a few notable exceptions, tax treaties today generally do no more than reaffirm the operation of the credit or exemption systems that most countries have unilaterally adopted to prevent double taxation", see Barthel, Fabian et al., 'The Relationship between Double Taxation Treaties and Foreign Direct Investment', in Lang, Michael et al. (eds.), *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), at p.6; Easson, supra note 93, at p.622; Hattingh, Johann, commenting the role of Art.1 OECD MC, supra note 51, at p.553; Sadiq, supra note 162, at p.164. Figueroa has in fact concluded that today, "international double taxation does not appear to be the true reason for negotiating tax treaties", see Figueroa, Antonio, 'International Double Taxation: General Reflections on Jurisdictional Principles, Model Tax Conventions and Argentina's Experience', in 59 *Bulletin for International Taxation* 8 (2005), at p.386.

[734] *Sportsman*, supra note 23, para.6.8.

seems to be whether, by restricting double assessments, double taxation is at the same time being avoided.

This is a hypothesis that the Four Economists explored almost a century ago. To them, there were two dimensions of the double taxation phenomenon: the *burden* and the *barrier*[735]. The *barrier* referred to the case of an investor who knew, before investing in a certain State, that he was going to be subject to double taxation as an effect of that operation[736]. The *burden*, on the contrary, referred to the case of an investor who, after having invested, was subject to a higher tax burden because of a subsequent modification of the laws of the State in which the operation was carried out[737]. While the Economists explained that there were advantages in preventing both types of double taxation, only the burden, that is to say, the risk of an increase in the rates of tax, would impose double taxation in a true sense[738]. The Economists suggested that the real danger they had to confront was the arbitrary exercise of a State's tax jurisdiction. What needed to be avoided, in order to promote cross-border activities, was the uncertainty as to the exercise of that power.

On the face of it, by simply existing, a tax treaty would be dealing with both types of double taxation. Even if its benefits are not actually exercised, the treaty eliminates the threat to cross-border activities that even potential double taxation is able to entail, which is in itself an obstacle. Hence, to sustain that "double taxation is neither a condition nor a prerequisite for invoking the protection of the treaty"[739] would not be entirely correct, unless the statement is restricted to cases of effective double taxation[740]. Double taxation, effective or potential, is theoretically relevant for the purposes of claiming the operation of a tax treaty. After all, tax treaties prevent 'not only "current" but also merely "potential" double taxation'[741].

Even the potential for double taxation (the burden) is indeed fundamental for the application of tax treaties, and there are more than enough reasons to sustain that treaties aim primarily at its avoidance[742]. Yet there is a significant difference between stating that double taxation is in theory required for a treaty to operate, than to state that a treaty could not operate if there is no effective double taxation to be avoided. This is precisely the core of the issue in relation to the identification of the object and purpose of the OECD MC underpinned by the existence of the term 'liable to tax'. It has been stated that:

> "[...] if there is no actual taxation by one country, there is nothing in the object and purpose of the convention to prevent taxation by the other"[743].

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735 The Four Economists in fact construed the theory of double taxation on the basis of double assessment, see LON, E.F.S.73.F.19, at p.7[4011].

736 In such a case the investor 'throws back upon the borrower the burden of the [respective] tax primarily or apparently placed upon himself (the non-resident investor), and, as an investor, is not in this event subject to double taxation', see LON, E.F.S.73.F.19, at p.7[4011].

737 LON, E.F.S.73.F.19, at p.7[4011].

738 '[...] taxation imposed in the country of investment, after the date of investment, of a weight greater than that anticipated or provided for by the investor, will impose double taxation in a true sense, from which the investor will find it difficult to escape owing to the effect of amortisation', see LON, E.F.S.73.F.19, at p.7[4011]. In the case of the barrier, in fact, the Economists explained that there was no real double taxation. Bearing in mind the knowledge of the circumstances of the investment, the investor 'throws back upon the borrower the burden of the [respective] tax primarily or apparently placed upon himself (the non-resident investor), and, as an investor, is not in this event subject to double taxation', LON, E.F.S.73.F.19, at p.7[4011].

739 *Chiron Behring*, supra note 349, para.20.

740 Because the application of the Model is not restricted to cases of effective double taxation only, see supra, Chapter 8, at pp.114ff.

741 Vogel, supra note 6, n.46a, at p.28.

742 Sasseville, supra note 687, at p.247; Ault, supra note 163, at p.263.

743 *Sportsman*, supra note 23, para.6.8.

While the allocation of tax jurisdiction may be seen as a simple mechanism designed to fulfil the ultimate purpose of the Model (namely the prevention of double taxation[744]), it appears that many States see the value of setting up agreements the applicability of which is not subject to the occurrence of effective double taxation. If this were not the case, there would be no reason for a State applying an exemption system to enter into an agreement such as the OECD MC. More often than not, tax treaties are concluded not only to avoid double taxation[745], but also to pursue other more general goals like certainty[746], a higher level of foreign direct investment[747], or merely to obtain a diplomatic "seal of approval"[748] for international operations[749].

Leaving that aside for the moment, it is nonetheless clear that an interpretation of the OECD MC in good faith requires the interpreter to attribute its meaning to the term 'liable to tax', considering that the OECD MC seeks to avoid double taxation *and* to allocate tax jurisdiction. The first step therefore lies in identifying the point in which the apparent mismatch arises.

In the context of the OECD MC, the incompatibility between the avoidance of double taxation and the allocation of tax jurisdiction originates while considering the cases of untaxed treaty claimants. The discussion arises each time a person that is not subject to effective double taxation claims the protection of tax treaties. In that case, while to some the application of the Model would be meaningless[750], others see no more than the product of the treaty bargain[751]: *pacta sunt servanda*. Arguably, the conflict would not arise if it were understood that double taxation is to be avoided if it arises but, in its absence, the rules of the treaty dealing with the allocation of tax jurisdiction should equally be observed.

It must be borne in mind that the core of the issue does not refer to the unfairness of double non-taxation or to the idea that non-taxation "should be addressed as much as double taxation"[752], which in current times enjoys a widespread sympathy[753]. The problem lies in an interpretation of

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744 Gouthière, Bruno, 'Key Practical Issues in Eliminating the Double Taxation of Business Income', in 64 *Bulletin for International Taxation* 4/5 (2011), at p.188.

745 Austria ensures the elimination of double taxation unilaterally. The purpose of entering into tax treaties is to promote economic development, to prevent avoidance and to provide certainty, see Loukota, H., et al., 'Austria's Tax Treaty Policy', in 58 *Bulletin for International Taxation* 8 (2004), at p.364.

746 The Fiscal Committee in fact defined its mission as "to delimit uniformly the Member countries' taxing powers on the international plane [so as to assist] the free development of economic relations between the Member countries of the OEEC, [and to] give European investors more certainty about the taxation obligations to which they will be subject", see C(57)145, at pp.5-6. The object of the rules proposed was only "to delimit taxation powers uniformly between the member countries in a certain number of cases where liability to tax arises", see C(59)147, at p.3; see also Wilkie, Scott, and Raizenne, Robert, 'Are (These) Tax Treaties Necessary?', in Maisto, G., et al., (eds.), *Essays on Tax Treaties*, (Amsterdam: IBFD, 2012), at pp.397-398.

747 Barthel, supra note 733, at p.17.

748 Easson, supra note 93, at p.622; Saunders, Roy, 'Understanding Double Tax Treaties', in 9 *Journal of International Trust and Corporate* Planning 1 (2002), at p.31; Sharkey, Nolan, 'China's Tax Treaties and Beneficial Ownership: Innovative Control of Treaty Shopping or Inferior Law-Making Damaging to International Law?', in 65 *Bulletin for International Taxation* 12 (2011), at p.655.

749 Avi-Jonah, Reuven, and HJI Panayi, Christiana, 'Rethinking Treaty Shopping: Lessons for the European Union', in Lang, M., et al., (eds.), *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), at p.28.

750 *Sportsman*, supra note 24, para.6.9.

751 "At the end of the day, a tax treaty is a bargain, a deal between two states on the allocation of revenue from trade and commerce between them", see Tadmore, Nic, *Source in the Digital Age*, (Melbourne: Clayton Utz, 2012), at p.20; Couzin, supra note 20, at p.109.

752 Avi-Jonah, supra note 749, at p.49.

753 Sasseville, supra note 687, at p.246; Achatz, supra note 464, at p.529; Lang, Michael, 'Double non-taxation' (General Report), in *Cahiers de Droit Fiscal International*, Vol.89a, (Amsterdam: IFA, 2004); Reimer, supra note 687, at p.464; Figueroa, supra note 733, at p.386; Durst, Michael, 'Fixing Double Nontaxation Under the Transfer Pricing

treaties leading to the conclusion that the avoidance of double taxation carries with it the need to prevent also the occurrence of non-taxation in the absence of any argument based on the text of the Model. While avoiding non-taxation may be reasonable, arguments must be given from the perspective of its text[754]. Further, the use of the term 'liable to tax' needs also to be considered. Raising the argument that the Model aims at the avoidance of non-taxation because its purpose is only to deal with double taxation disregards the fact that a number of States consider the occurrence of non-taxation as a means to implement certain policy objectives. This would be the case, for instance, of any State applying the capital-import neutrality principle. From their perspective the argument is not only artificial, but it also overwhelms their sovereign right to decide what to do in the sphere of their own jurisdiction[755]. From the standpoint of any potential treaty partners, there would be no purpose in entering into treaties with such a country: firstly, because double taxation would already be avoided at the domestic level; and secondly, because that would reduce its margins of action in granting domestic tax incentives when acting as the State of source[756].

The need to avoid double non-taxation as an object and purpose of a tax treaty must be extracted from the text of the agreement and cannot be sustained on the basis of the intention that the parties may be presumed to have had[757]. In interpreting a tax treaty, one must keep in mind that "the relevant question is not so much what a treaty was intended to say, but rather what it actually says"[758]. If the need to counter non-taxation is built by implication, its reasonableness will always be debatable.

9.4.6.5. Avoidance of double taxation and avoidance of double non-taxation

As has been suggested earlier, some courts, in a rather noble attempt to counter the use of tax treaties in abusive situations, have attempted to argue that tax treaty benefits should not be recognised if they were to result in double non-taxation. According to the judge in the Sportsman case:

> "Double taxation conventions are not to create or allocate taxing rights, but to prevent double taxation. The taxing rights already exist. By entering into a double taxation convention each government relinquishes all or part of its taxing rights according to domestic law in certain circumstances; one country gives up its claim in recognition of the fact that the other is going to take it. However, *if there is no actual taxation by one country, there is nothing in the object and purpose of the convention to prevent taxation by the other*. Double taxation is still being eliminated."[759]

Guidelines', in 66 *Tax Notes International* 9 (2012), at p.839; Nouwen, Martijn, 'The Gathering Momentum of International and Supranational Action against Aggressive Tax Planning and Harmful Tax Competition: The State of Play of Recent Work of the OECD and European Union', 53 *European Taxation* 10 (2013); Bärsch, S., and Spengel, C., 'Hybrid Mismatch Arrangements: OECD Recommendations and German Practice', in 67 *Bulletin for International Taxation* 10 (2013); Owens, Jeffrey, 'The Taxation of Multinational Enterprises: An Elusive Balance', in 67 *Bulletin for International Taxation* 8 (2013), at p.444.

754 Other tan simply following a subject-to-tax approach in interpreting the term 'liable to tax', grounded on the need to avoid double taxation from the perspective of the Model.

755 The history of the Model aims clearly in this direction, see FC/WP2(57)2, at pp.2-5; FC/M(60)1, at p.9; and specially the statement that "if a country was given the right to tax, it should also be given the right not to levy the tax for certain economic reason" in FC/M(60)3, at p.5.

756 "Where the State of residence gives relief by the exemption method no problem arises because the taxpayer is not deprived of the incentive relief granted in the State of source", see FC/WP15(59)1, at p.16. This feature of treaties was crucial because any limitations on it "might deprive the country of source of the result it seeks to achieve by not taxing certain kinds of income", see the opinion of the Delegate for the Netherlands, FC/M(60)1, at p.9.

757 According to Vogel, '[i]t is even less acceptable for a court to use as a basis of interpretation that which it presumes the parties must have intended', see Vogel, supra note 6, n.69a, at p.37.

758 Engelen, supra note 448, at p.427.

759 Emphasis added. *Sportsman*, supra note 23, at para.6.8.

In the Bayfine case, on the other hand, it was stated that:

> "The fundamental purpose of the Double Taxation Treaty is to ensure that persons or organisations that fall within it are not taxed twice in different countries. The converse is also of course to ensure that reliefs are not given twice either"[760].

The OECD, which decided to take action given the public outrage caused by the issue of base erosion and profit shifting quite recently, tried to catch the essence of these denunciations as if they were its own:

> "[…] some rules and their underlying policy were built on the assumption that one country would forgo taxation *because another country would be imposing tax*. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere"[761].

When this statement is read for the first time, it generates the strange feeling that the OECD may be referring to another treaty model, and not to the OECD MC. In spite of the support this idea has found in literature[762], it is evident that the Model was not built on the assumption that at least one State would tax the relevant income. On the contrary, as the history of the OECD MC so clearly demonstrates, the OECD MC contains an absolute duty to provide an exemption[763], not an obligation to relieve double taxation[764].

As was discussed in the Fiscal Committee:

> "[…] the Convention ought not to be restricted to the avoidance of actual double taxation, but should on the contrary settle the attribution of the right to tax between the States."[765]
>
> "The rule proposed by the Working Party aims only at the apportionment of the right to tax which is attached to residence, but it can never result in a residence State acquiring the right to tax an income which, as the residence State, it has renounced its right to tax."[766]

Moreover, as Working Party 12 so neatly explained:

> "The proof of liability to taxation in his State of residence is only to the effect that the viewpoint of the dividends is liable in principle to tax on them; it does not imply that a tax has actually been paid to them. Furthermore, the Working Party thinks that it should be sufficient if the dividends are added to his taxable income. The State of source should also give relief from its tax when, owing to losses or social security deductions or to the receipt of income exempt from tax, etc., the taxpayer pays no tax. *The evidence of liability in the other State is not therefore in the nature of a clause designed to prevent effective double taxation alone*."[767]

The Model was clearly not meant to prevent double taxation alone, which is another way of saying that the avoidance of double taxation did not carry the need to avert also double non-taxation. The Model was designed as an instrument which, in the absence of double taxation, would nevertheless operate as an agreement for the allocation of tax jurisdiction, to provide certainty to

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760 United Kingdom, High Court of Justice, 23 March 2010, *Bayfine v. HMRC*, [2010] EWHC 609 (Ch), at para.63; later confirmed by the Court of Appeal, see *Bayfine*, supra note 560, at para.52-53.
761 Emphasis added. OECD, *Addressing Base Erosion and Profit Shifting*, supra note 27, at p.47.
762 Van Weeghel, supra note 133, at p.33 and at p.105; de Broe, supra note 496, at p.357.
763 See supra Chapter 8, at pp.103ff.
764 Arnold, Brian, 'Taxing Business Profits', in 56 *Bulletin for International Taxation* 6 (2002), at p.264.
765 FC/M(60)1, at p.9, opinion by the Delegate for The Netherlands. When discussing the methods of relief, this opinion predominated and it is still present in Sec.35 of the Commentary to Art.23 OECD Model Convention (2014), under the "absolute obligation on the State of residence to give exemption", see FC/WP2(57)2, at p.2.
766 FC/WP2(57)2, at p.2.
767 Emphasis added. FC/WP12(58)1, at p.15.

cross-border activities. At least this what the Fiscal Committee explained in relation to the purpose of these rules:

> "[…] to delimit uniformly the Member countries' taxing powers on the international plane [so as to assist] the free development of economic relations between the Member countries of the OEEC, [and to] give European investors more certainty about the taxation obligations to which they will be subject"[768].

> "[…] to delimit taxation powers uniformly between the member countries in a certain number of cases where liability to tax arises"[769].

Furthermore, in relation to the possibility of including subject to tax clauses in tax treaties, in 1992 the OECD added the following statement to the Commentaries:

> "This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision"[770].

When attributing its meaning to the term 'liable to tax', it is one thing to sustain that the Model should deal with the issue of non-taxation[771] (which is a fair and reasonable argument), and it is quite another thing to successfully claim it does on the basis of its text. While it is fair to argue that income should be subject to at least some tax, it is relatively clear that non-taxation is a contemplated effect of the OECD MC[772]. Thus, "the contracting States must implement a subject-to-tax clause if they want to prevent double non-taxation"[773], because the avoidance of non-taxation is clearly not a purpose behind the OECD MC[774].

9.4.6.6. 'Liable to tax' and the prevention of avoidance and evasion

Although the issue of tax avoidance (and particularly the possibility of finding any support for it as an object and purpose of the Model in its text[775]) largely supersedes the boundaries of this work, it must be mentioned, even briefly, that to some non-taxation needs to be avoided because one of the purposes of tax treaties is the prevention of tax avoidance:

> "These words, however, make it clear that the primary purposes of the Treaty are, on the one hand, to eliminate double taxation and, on the other hand, to prevent the avoidance of taxation. In seeking a purposive interpretation, both these principles have to be borne in mind. Moreover, the latter principle, in my judgement, means that the Treaty should be interpreted to avoid the grant of double relief as well as to confer relief against double taxation."[776]

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[768] C(57)145, at pp.5-6.
[769] C(59)147, at p.3.
[770] Sec.15 of Comm. to OECD Model Convention (2014).
[771] Avi-Jonah, supra note 749, at p.49; Sasseville, supra note 687, at p.246; Galea, supra note 208.
[772] Schwarz, supra note 307, at pp.457. See in particular the analysis of Lang in relation to Art.20 OECD MC in Lang, Michael, 'Does Art.20 of the OECD Model Convention Really Fit into Tax Treaties?', in Baker, Ph., et al., (eds.), *Tax Polymath*, (Amsterdam: IBFD, 2010), at p.264-265; and Couzin, supra note 20, at pp.107-111.
[773] Achatz, supra note 464, at p.529; Burgstaller, supra note 464, at p.276.
[774] De Broe, supra note 496, at p.357; Burgstaller, supra note 464, at p.266; Kleist, supra note 555, at p.265.
[775] On the effectiveness of this approach in relation to the little support if finds in the text of the Model see Arnold, Brian, and van Weeghel, Stef, 'The relationship between tax treaties and domestic anti-abuse measures', in Maisto, G., (ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), at pp.89-90; Arnold, Brian, 'Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model', in 58 *Bulletin for International Taxation* 6 (2004), at p.249; Zonorza, Juan and Báez, Andrés, 'The 2003 Revisions to the Commentary to the OECD Model on Tax Treaties and GAARs: A Mistaken Starting Point', in Lang, Michael, et al., (eds.), *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), at pp.155-156; Maisto, supra note 611, at pp.335-336.
[776] *Bayfine*, supra note 560, at para.17 and para.40. On the matter see Arnold, 'Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model', supra note 775, at pp.244-260.

By introducing a change to the Commentaries, the OECD has intended to promote the idea that tax treaties aim at the prevention of tax avoidance[777]. The 2014 Public Discussion Draft on treaty abuse, published in the context of the BEPS initiative, promoted a change to the title of the Model as well, so as to include the prevention of avoidance and evasion as a purpose of tax treaties[778]. Moreover, the OECD has proposed some modifications to the preamble to the Model to clarify that treaties cannot be used in "creating opportunities for non-taxation or reduced taxation *through tax evasion or avoidance*"[779]. All these new features form part of a strategy to achieve a certain interpretation of the Model, given the fact that the general rule of interpretation enshrined in Art.31 of the VCLT considers, as was stated earlier, the object and purpose of the agreement[780].

Avoidance and evasion represent fraud and deception. Although the limit which separates one from the other is hard to identify[781], it is relatively clear that while tax avoidance is not strictly illegal, tax evasion is[782]. At the core of both of them, however, lies the unmistakable intention of deceiving. Yet the fact that the application of a tax treaty may result in double non-taxation cannot so lightly be taken to imply a fraud, and this is in a way clarified by the work of the OECD in the field of BEPS[783]. As stated in the previous paragraph, the OECD has left it sufficiently clear that non-taxation is forbidden only in cases of *evasion and avoidance*. In other words, any double non-taxation caused in a context of at least some economic substance was outside the scope of the BEPS initiative[784], and it is therefore not questionable from the perspective of good faith.

When the OECD explains in the context of BEPS that the issue of double non-taxation is only relevant insofar as it may constitute tax avoidance and evasion, it reinforces that conclusion[785]. Thus, if the question were raised: "can the broad statement that the purpose of a tax treaty includes the prevention of tax avoidance override the clear meaning of the words of the provisions of the treaty?"[786], the answer seems to be negative. In judging the appropriateness of a treaty claim leading to non-taxation one must always keep in mind that, according to the rules of the Model and its history, non-taxation is a natural effect of its application. Hence, it is submitted that the occurrence of non-taxation does not imply and cannot imply in itself the existence of tax avoidance[787]. On the contrary, each time an argument is made of the dishonest conduct of a

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777 Sec.7 of Comm. to Art.1 OECD Model Convention (2014).

778 OECD, Public Discussion Draft, supra note 27, at p.27. The proposed title for the OECD MC is: "Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance". This change was ratified in the final version of the BEPS Report, see OECD, Action 6: 2015 Final Report, supra note 1, at p.91. It is relevant to notice the inclusion of the avoidance of double taxation as part of the title, after having been carved out from it, see Sec.16 of the Introduction to Comm. to OECD MC (2014).

779 Emphasis added. OECD, Public Discussion Draft, supra note 27, at p.28. This is also stated in the field of hybrid mismatch arrangements, see OECD, Public Discussion Draft, supra note 510, at p.13.

780 OECD, Public Discussion Draft, supra note 27, at p.28; OECD, Action 6: 2015 Final Report, supra note 1, at p.92.

781 Avi-Jonah, supra note 749, at p.27.

782 Tixier, Gilbert, *Droit Fiscal International*, (Paris: PUF, 1995), at p.13; Arnold, 'Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model', supra note 775, at p.247.

783 Generically speaking, in the words of the OECD, the presence of abuse "should not be lightly assumed", see OECD, Action 6: 2015 Final Report, supra note 1, at p.81. Accordingly the fraud needs to be proved, see Arnold, Brian, 'Tax Treaty News', in 63 *Bulletin for International Taxation* 12 (2009), at p.563; Arnold, supra note 775, at p.247.

784 See OECD, Public Discussion Draft, supra note 27: "[n]o or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it", see Action Plan, supra note 27, at p.10.

785 Recently, the OECD has explained: "In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its main purpose will be considered to be the obtaining of that benefit", OECD, Public Discussion Draft, supra note 27, at p.12.

786 Arnold, Brian, 'Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model", supra note 775, at p.248; de Broe, supra note 496, at p.334; and Zonorza, supra note 775, at p.156.

787 See Schwarz, supra note 307, at pp.456-457.

taxpayer, the fraud needs to be demonstrated[788]. The occurrence of double non-taxation, although it may indicate the presence of a tax avoidance strategy[789], can under no circumstances constitute a presumption of its existence. The proposed change to the title of the OECD MC is not going to resolve the issue of non-taxation, because double non-taxation cannot constitute *per se* tax avoidance or evasion.

Most notably, because double non-taxation is not forbidden by any element of the Model, its underlying object and purpose cannot be used as an excuse to drive the attribution of its meaning to the term 'liable to tax', as if it were a synonym of the expression 'taxed'.

9.4.6.7. Evaluation: The ordinary meaning of 'liable to tax' in the context of, and in the light of the object and purpose of, a model tax convention

The OECD has put a lot of effort in elaborating a treaty model which may be applied in practically any scenario, and this result has been achieved by taking an unclear path in practically every key aspect of residence. The OECD has in fact attracted many States, some of them holding substantially different tax regimes, to the use of its model tax convention. These States see an actual chance of materialising the different policy objectives they pursue by using the text proposed. As an effect of this, tax treaties based on the exact same text of the OECD MC and interpreted in the light of the same Commentaries may be taken to produce opposite results. The problem this entails is, logically, that the application of the Model may also be questioned in almost any circumstances.

The OECD has in fact carefully dodged all the fundamental issues in relation to tax treaty entitlement so as to promote the use of its Model. Well aware of the fact that the imposition of effective taxation as a condition for residence could discourage its adoption by a number of States[790], the OECD has taken a series of strategic decisions. Firstly, it carved out the mention to double taxation from the title of the OECD MC[791]. Instead of *double taxation conventions*, tax treaties must be properly referred to as "Conventions on Income and Capital"[792], a formula that says little about their purpose and does much in introducing uncertainty. Secondly, at a certain point in time it clarified the principal purpose behind the agreement:

> "The *principal purpose* of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. "[793].

While the avoidance of double taxation certainly promotes international trade and investment, one may reasonably wonder how double non-taxation does not give incentives to cross-border activities. Given the manner in which the OECD has stated the *principal purpose* of the Model, the only reasonable way to sustain that that double non-taxation must be avoided, would be to argue that its occurrence does not suppose any incentives to cross-border operations. On the contrary, it

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788 On a case by case basis, see Resch, supra note 470, at p.483.

789 Avi-Jonah, supra note 749, at p.50.

790 Most notably but not restricted to States applying capital-import neutrality and territorial systems. Early during the discussion of the Model, that was in fact qualified as "retrograde step", see FC/M(60)1, at p.9.

791 The explanation was: "In both the 1963 Draft Convention and the 1977 Model Convention, the title [...] included a reference to the elimination of double taxation. In recognition of the fact that the Model Convention does not deal exclusively with the elimination of double taxation but also addresses other issues [...] it was subsequently decided to use a shorter title which did not include this reference", see Sec.16 of Introduction to the OECD Model Commentaries.

792 The title of the OECD MC was modified to that effect in 1992. In 2015, as a result of the BEPS project, a change to the tittle was proposed so as to include the purpose of eliminating double taxation.

793 This clarification was introduced in 2003, see Sec. 7 of Comm. on Art.1. OECD Model Convention.

is clear that it does, and the OECD itself has gone as far as expressing that double non-taxation can operate as an acceptable comparative advantage in favour of a cross-border setting[794]. To leave such a crucial aspect open to interpretation is a keystone for the widespread adoption of the agreement as a model, especially in States applying an exemption system.

Other than the fruit of trepidation, it seems that the attitude of the OECD has been actively directed to feed an ambiguous interpretation of the Model both in relation to the context in which its expressions are used, and in relation to the object and purpose it pursues. On the one hand, it has expressed some concerns in the field of double non-taxation[795], while on the other hand explaining that not every case of non-taxation is harmful[796]. In fact, it has clarified that a subject-to-tax approach is definitely not implied in the Model[797] and should actually be avoided[798]. Further, it has declared that some States accept tax treaty entitlement of tax-exempt entities[799] while recognising that other States reject it[800]. It has argued that persons whose entire foreign income is tax-exempt should be excluded from the application of the Model[801], while clarifying simultaneously that the purpose of the rule is not to exclude persons who are residents of States applying a territorial system of taxation[802]. It has stated that tax treaties may not be applied in cases of treaty shopping[803] and profit shifting[804], while at the same time declaring that the OECD MC does not impose standards for residence under the domestic laws of the respective States[805], knowing full well that the laws of some States tolerate what is, under the noble intention of fighting artificial arrangements, plainly unacceptable[806]. Remarkably, it is in the context of such an agreement that, in the abstract, a comprehensive object and purpose must be identified so as to attribute its meaning to the expression that holds the key for the application of the treaty as a whole. One must struggle to identify the object and purpose behind the OECD MC[807] when attributing the term 'liable to tax' its ordinary meaning.

Across the length of this study some relevant elements of context have been studied with the intention to throw light as much as possible on the position of the OECD in relation to some key aspects of treaty entitlement. After having doing so, it is hardly sustainable that, as it stands, the OECD MC aims primarily to any precise object and purpose other than the ambiguous need to promote exchanges of goods and services and the movement of capital and persons.

It is therefore stated that, under such conditions, an interpretation of the OECD MC in good faith cannot safely lead to the conclusion that the avoidance of double taxation is the primary purpose of treaties, let alone that it carries the need of preventing double non-taxation[808]. Even if one persists in identifying the avoidance of double taxation as the primary object and purpose at

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794 OECD, Addressing BEPS, supra note 27, at p.28.
795 OECD, Addressing BEPS, supra note 27, at p.11.
796 But only one that arises as a product of an artificial segregation of income from its source, which reduces the problem to an issue of relevant substance and not of non-taxation in itself, see Action Plan, supra note 27, at p.10.
797 Sec.35 of Comm. to Art.23 and Sec.3 of Comm. to Art.21 OECD Model Convention (2014).
798 Sec.15 of Comm. to Art.1 OECD Model Convention (2014).
799 Sec.8.6 of Comm. to Art.4 OECD Model Convention (2014).
800 Sec.8.7 of Comm. to Art.4 OECD Model Convention (2014).
801 Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).
802 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).
803 Sec.8 of Comm. to Art.1 OECD Model Convention (2014).
804 OECD, Addressing BEPS, supra note 27, at p.84.
805 Sec.4 and 8 of Comm. to Art.4 OECD Model Convention (2014).
806 Such as the recognition of residence on the basis of incorporation.
807 "As follows from the findings in chapter 7 it is difficult to determine the object and purpose of a treaty", see van Weeghel, supra note 133, at p.177.
808 Lang, supra note 753, at pp.86-87.

which the Model aims[809], if no arguments are presented from the perspective of its text so as to demonstrate that double non-taxation is in fact forbidden, then the operation of the treaty should be limited to avoiding double taxation where it occurs. One must always keep in mind that a "treaty does not forbid that which it does not provide for"[810] and, consequently, any effort to sustain such arguments by way of implication, overlooking the terms under which the agreement has been reached, would be fruitless and must be abandoned.

Further, it must also be accepted that the lack of a clear definition of the purpose of the Model from the perspective of its text prevents from knowing with certainty whether the benefits of a treaty based on the OECD MC are unintended or not, and whether the presence of abuse may successfully be argued. In fact, "to the extent that the object and purpose of tax treaties and specific treaty provisions are unclear, the application of an inherent anti-abuse principle is necessarily uncertain and difficult for courts to apply and taxpayers to follow"[811]. Inasmuch as the object and purpose behind the Model is meant to support any possible treaty claim, there will be no truly *improper* use of the convention, but a fundamental lack of agreement in relation of what *improper* really means. The dividing line for a breach of good faith will remain hardly identifiable and inescapably debatable.

Avery Jones has gracefully explained that it is the excess of rules, both in number and complexity, combined with a narrow semantic approach on their interpretation, that leads to the application of those rules for the purposes of tax avoidance[812]. According to Avery Jones, a simpler formulation of the law combined with a purposive interpretation of statutory provisions would lead to a more reasonable application of those rules. The excessive complexity of the definition of residence in the OECD MC indeed leads to perplexing results, and so this approach seems to point in the right direction. However, Avery Jones has also acknowledged that the application of such a methodology is only possible if the underlying principles and the object and purpose behind the rules interpreted are clear and consistent[813]. Regrettably, as has been largely explained before, this does not seem to be the case of the OECD MC as a model treaty.

9.5. Evaluation: The ordinary meaning of the term ''liable to tax' in the light of the VCLT

The issues in relation to the application of Art.4 OECD MC do not derive exclusively from the use of the expression 'liable to tax', but from the manner in which the OECD MC has been structured. The inconsistencies in the Model would affect a decision on treaty entitlement even if the term 'resident of a contracting State' were formally left undefined or defined in a different manner. This strengthens the conclusion that the question in relation to residence is not only a legal question, but also one that needs to be answered from a more fundamental *policy* perspective. The chances of solving the issues derived from the term 'resident' in the Model by attributing its meaning to the term 'liable to tax' is highly limited.

When seeking to apply the VCLT to attribute its meaning to the term 'liable to tax' in a fair, honest and reasonable manner, one cannot ignore the fact that the term has been employed in a confusing context, and that it forms part of an agreement the purpose of which is rather uncertain. This is the reason why at times the term seems to set out only a redirection to the laws of the

809 Sasseville, supra note 687, at p.247.
810 Message, supra note 238, at p.221.
811 Duff, supra note 157, at p.94.
812 This may be the reason why some courts have moved from a literal to a more purposive approach on statutory interpretation, see Avery Jones, John, 'Tax Law: Rules or Principles?', in 17 *Fiscal Studies* 3 (1996), at p.71.
813 Avery Jones, supra note 812, at p.88.

States defining the term 'resident', while other times it seems to be setting out obstacles or *standards* to access its benefits in cases that are questionable from many angles. As a model treaty the OECD MC needs to be capable of doing both things at the same time. This is but a product of OECD's work embodying "a contest of principles, in which cooperation and competition are in constant tension, and in which some factors promote one principle over the other while others attempt to promote both at the same time, and in which positions may change with political winds"[814].

The words used in the OECD MC and particularly those in the rule of residence have been meticulously drafted to meet the policy expectations of States pursuing myriad and conflicting domestic interests. This conclusion is critical taking into consideration that the function of the term is to provide access to the treaty as a whole, but it is particularly relevant if one considers that the rule is also meant to set the boundaries for a breach of good faith. It is the agreement of the parties that operates as a point of reference to determine whether the benefits of a treaty are improper, but again, this is essentially in light of how the parties have set up their agreement.

The rule of residence fails to fulfil its primary and foremost function by not clarifying in which circumstances the application of treaty benefits seem to be adequate. The term 'liable to tax' must be interpreted with the view of recognising an effect on the expression and on the treaty as a whole, yet if the question were raised as to the effect that tax treaties are supposed to produce, again, that question seems to be impossible to answer from a unique perspective. It is relatively clear that, for instance, the expected effect of a tax treaty will not be the same in a State applying capital-import neutrality and that in a State applying capital-export neutrality, or in a State seeking to promote inbound or outbound investment. This would probably affect the interpretation of the term 'liable to tax'. However, this is natural taking into consideration that the term is meant to open the door to a *model tax convention*.

Perhaps the most valuable conclusion that may be extracted from the analysis of the term 'liable to tax' under the VCLT is that the object and purpose of a tax treaty gathers all the different objectives the agreement is meant to confront, not in the abstract, but from the particular perspective of States which have decided to enter into a treaty. The Model as it stands, as a *model tax convention*, aims at avoiding double taxation as much as it seeks to allocate tax jurisdiction, and both purposes operate on an equal foot when attributing its meaning to the term 'liable to tax'. Whether double non-taxation needs to be avoided, on the other hand, is a question that, being confronted from the perspective of the text of the Model (and not by implication), does not seem to lead to a positive answer. Not even the need to prevent avoidance and evasion is able in itself to thwart the application of the Model in scenarios of non-taxation. All these interpretations do no violence to the principle of effectiveness and the reason for this is simple: the Model ought not to operate at all cost to avoid effective double taxation.

This is why it is so fundamental, as was expressed before, that the States which consider the possibility of entering into a tax treaty take every reasonable measure to clarify, in the text of the agreement, what the purpose they seek to fulfil is and what the conditions on which entitlement to the agreement will be granted are. It is crucial, for the purposes of a reasonable application of a tax treaty, to express this purpose consistently throughout its provisions, but it is particularly relevant when determining the person allowed to claiming its benefits. By doing so, they will reduce significantly the potential for conflicts in the interpretation and application of their tax treaties.

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[814] Christians, supra note 85, at p.145.

PART III

POLICY CONSIDERATIONS AND CONSTITUTIVE ELEMENTS OF RESIDENCE IN JUDGING THE APPROPRIATENESS OF A TAX TREATY CLAIM

10. Chapter 10
Residence and treaty abuse: Policy considerations in the definition of residence and the improper entitlement to tax treaties under Art.4 OECD MC

10.1. Introduction. Residence in granting access to intended treaty benefits

It is commonly assumed that Art.4 OECD MC contains only a redirection to the laws of the States dealing with residence domestically, and that no standards are imposed on those residents to access the benefits of tax treaties. As has been stated earlier, this is not a coincidence. Historically, this was the original idea behind the OECD MC.

The presence of a definition of residence in the Model and the rise of the issue of treaty abuse, however, seem to have changed this conception of the Model. After all, the need to define residence at the treaty level would only be justified if its purpose were to exclude certain domestic claims from the scope of the Model[815]. This seems to have been at the heart of the observations made by the Delegate for the United States in 1962, when the issue of treaty abuse was raised for the first time.

This is nonetheless a complicated issue. The ability to deal with scenarios of perceived abuse is an aptitude one would expect from a reasonable rule of tax treaty entitlement. However, the application of Art.4 OECD MC in those scenarios has led to no consensus. Treaty benefits in the case of conduit companies, for instance, have been qualified as abusive[816], unintended[817], improper[818], and more recently as inappropriate[819] and unduly obtained[820], and yet these entities cannot easily be put aside when analysing the scope of the definition of residence. It appears that the fundamental questions posed by the issue of treaty abuse are, on the one hand, whether Art.4 OECD MC has the ability to tag certain treaty claims as abusive and, on the other hand, whether the rule is in fact apt to discriminate these claims from a policy perspective.

The following section explores the issue of treaty abuse solely from the perspective of Art.4 OECD MC, in an attempt to answer the question of whether the definition of residence has the appropriate means to deal with the issue of abuse from a policy perspective. The rules proposed by the OECD in the context of the BEPS initiative to deal with this issue, namely a limitation-on-benefits provision and a general anti-abuse rule[821], and their effect of the attribution of its meaning to the term 'liable to tax' are discussed in a separate chapter.

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815 Residence generates the authority to claim treaty benefits, Vogel, supra note 6, n.9, at p.223.

816 Sec.9 of Comm. to Art.1 OECD Model Convention (2014).

817 Sec.9.3 of Comm. to Art.1 OECD Model Convention (2014).

818 Sec.7-26 of Comm. to Art.1 OECD Model Convention (2014). The reference to 'improper' treaty benefits was introduced in 1962 to refer to abusive cases, see TFD/FC/136.

819 OECD, Public Discussion Draft, supra note 27.

820 The OECD has suggested the need of "changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual residents) are not used to obtain the benefits of treaties *unduly*" (emphasis added), see OECD, Public Discussion Draft, supra note 510, at p.4; OECD, Public Discussion Draft, supra note 500, at p.5; and the final version in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements. Action 2: 2015 Final Report*, (Paris: loose-leaf, October 2015), at p.137.

821 A general anti-abuse rule and a limitation-on-benefits provision have been proposed to be added to the OECD MC in 2015. Their effect on the attribution of its meaning to the term 'liable to tax' is explored in Chapter 11.

10.2. The ability of the term 'resident' to define treaty abuse

10.2.1. Fundamental policy behind the definition of residence

Regardless of the fact that the definition of residence should be appreciated from the perspective of the text of the agreement as a whole, tax treaties are not only made of rules. There can be no access to tax treaties without prior evaluation of the appropriateness of a certain treaty claim. In that respect, the rule of residence in the Model has historically played a fundamental role.

Setting up a rule of treaty entitlement such as the definition of residence presupposes the existence of an agreement in relation to the cases in which the application of a tax treaty is considered relevant for the parties. In the case of tax treaties, for instance, the issue of 'domicile' was one of the first aspects ever discussed[822]. The personal scope of application of a treaty is a fundamental piece of the treaty bargain, given the consequences it entails both politically and economically for the parties[823].

The negotiation of a tax treaty therefore allows the assumption that the parties must have an interest in recognising the benefits of a treaty. According to the interest they pursue, they will either plan to circumscribe the application of their arrangement to certain specific cases, or they will establish a broad scope to access it. On the basis of this decision they will draft their rule of treaty entitlement.

Being the definition of the subject entitled to treaty benefits a cornerstone for the later interpretation and application of the agreement, it would not be reasonable to presume that the construction of the rule has been immaterial for the parties. On the contrary, the conclusion of a tax treaty entails the confrontation of fundamental interests by the contracting States, in good faith, in relation to the result they seek to achieve by entering into it. Thus, the need to implement a certain policy objective from the domestic perspective suggests that each State's domestic rules play a crucial role in defining the cases in which each of the States will find the application of the treaty desirable.

The parties, however, will not only be presumed to have an interest in drafting the rule which grants access to treaties in a certain manner under their own perspective, but also the viewpoint of its counterparty will be relevant, if not crucial[824]. In the context of a reasonable treaty negotiation, it would be safe to assume that each State has taken all reasonable measures to examine the rules of its counterparty[825], so as to detect any situations in which the application of the agreement may be considered to be either positive or detrimental. As early as in 1956, Working Party 2 of the OECD examined this aspect of the definition of residence in its Model, and stated:

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822 The matter of domicile was one of the first aspects of tax treaties to be considered, see C(55)307, at p.3.

823 The scope of persons covered has varied depending on the object pursued by the parties: 'Whereas older Conventions in general were applicable to "citizens" of the Contracting States, recent Conventions usually apply to "residents" [...]. Some Conventions are even of wider scope inasmuch as they are applicable more generally to "taxpayers" of the Contracting States [...]. As the Convention, however, is intended to be applied between Member countries of the O.E.E.C., it has been deemed preferable for practical reasons to limit its application to "residents" of the Contracting States only', see TFD/FC/89, at p.2.

824 Van Weeghel and Gunn have explained that "If it can be unequivocally established that *both* contracting states would regard a particular instance of taxpayer conduct as an abuse of the tax treaty, [...] logic dictates that the granting of treaty benefits cannot have been intended" (emphasis added), see supra note 600, at p.323.

825 De Broe, supra note 496, at p.359.

> "When concluding a double taxation agreement, each of the states must be presumed to have made a mutual examination of the concept of domicile of the other state and found it satisfactory; for the rest a state will always have a possibility of terminating its tax renunciation by denunciation of the agreement." [826]

The examination the States are expected to make of the rules of its counterparty is fundamental for the balance and reciprocity of a tax treaty. By way of illustration, some States would recognise the interest in allowing access to tax treaties to certain tax-exempt persons, while others would not[827]. Some States will find it reasonable to extend the benefits of a tax treaty to companies incorporated in their jurisdiction, while other States will make a case for requiring substantial presence therein[828]. In the context of a negotiation carried on in good faith, it would not be reasonable to suppose that such fundamental features of each State's system were considered to be irrelevant by the parties.

The rules through which tax treaty entitlement is defined are, at the outset, a crucial vehicle for policy considerations, because rather than providing access to a simple set of rules, the definition provides access to the policy behind the treaty as a whole. It is worth noticing that the interest behind such an agreement will naturally have a relative character, inasmuch as it will represent the local concerns that led to the conclusion of a treaty in each case at any given time[829]. This implies that the consequences of having assembled the rule of treaty access under certain terms and in a given context must be appreciated on a case-by-case basis.

When analysing the definition of residence in Art.4 OECD MC, one must keep in mind that the OECD MC has been drafted as a model treaty, with the express aim of being used as it stands in a variety of different scenarios. In that character, it must be capable of representing a broad scope of policy considerations[830], because the States which do not see the possibility of achieving their domestic objectives through the proposed text will probably refrain from using it. On the basis of this, the possibility of fundamental divergences is almost certain. There is the intrinsic risk that the lack of an authentic agreement at the policy level will be concealed by the use of a model treaty which aims at not excluding any precise form of tax treaty entitlement, thus perpetuating the future problems derived from its interpretation.

By way of illustration, when analysing the definition of residence in Art.4 OECD MC one may be led to believe that cases of treaty shopping should be excluded from the Model because they are questionable from a policy perspective. Although to some this may seem to be obvious, this is not a conclusion that may be drawn effortlessly. On the contrary, it requires a certain analysis. Some States have indeed made a case for applying tax treaties in circumstances of treaty shopping[831],

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826 FC/WP2(56)1, at p.7.

827 Sec.8.5 and 8.6 of Comm. to Art.4 OECD Model Convention (2014).

828 Sec.20 of Comm. to Art.1 OECD Model Convention (2014).

829 Vann explains some policy considerations in relation to the corporate residence test, see Vann, supra note 41, at pp.259-263. See also de Broe, supra note 825, at pp.348-349.

830 Vogel, supra note 6, n.81, at p.45. According to de Broe, however, "it is not the OECD that ultimately sets the policies of its Member Countries […] Tax treaties are compromises and thus in the end each Contracting State sets its own policy", see de Broe, supra note 496, at p.348.

831 According to van Weeghel, this has been the position of the Netherlands Supreme Court, see van Weeghel, supra note 133, at p.171. This has also been declared by Indian courts, see *Azadi Bachao Andolan*, supra note 25. For a description of the position of India in the field of treaty shopping see also Avi-Jonah, supra note 749, at p.29. Although the validity of *Azadi Bachao* has been questioned on several occasions, the Supreme Court of India has upheld it each time, see by way of illustration Supreme Court of India, *Vodafone International Holdings BV v. Union of India*, (2012) 6 SCC.

while to other States this situation is plainly unacceptable[832]. The OECD MC has nonetheless been drafted in a way in which both States may use its text in order to carry on the policy considerations they consider to be valuable.

10.2.2. The function performed by the definition of residence

From an historical perspective, the term 'resident' was chosen precisely because it allowed a more comprehensive scope of application than its predecessor, 'fiscal domicile'[833]. In line with this need, the concept has traditionally been attached a positive function, which is that of *providing access* to tax treaties[834]. Yet, it appears that the issue of treaty abuse raised in 1962 introduced the need of looking at the issue of the function performed by the rule of residence from a negative perspective. A proper rule of tax treaty entitlement should not only describe the cases in which the benefits of a treaty can be availed but it should also, and perhaps more importantly, operate as a barrier for those claims which seem to be inappropriate from a policy perspective. In a way, this suggests that the negative function the term 'resident' is expected to perform is as relevant as the role played by the term in guaranteeing access to tax treaties.

Absent additional rules in the Model[835], if there are reasons to discuss the application of treaties in scenarios of profit shifting, treaty shopping or non-taxation, they all seem to be connected to the negative function the expression 'resident' is meant to perform, or to the lack of a complete understanding of it. It cannot be forgotten that the term operates as the gateway to treaty benefits, and thus the definition of residence sets out, for better or worse, the requirements for a treaty claimant to succeed.

Whether the definition of residence is apt to discriminate tax treaty claims, or if such a relevant quality may be attributed to the definition on the basis of the Model as it stands is rather doubtful. Yet, one needs to not confuse the two fundamental questions at the core of this issue. It is one thing to discuss whether conduit companies should be entitled to treaty benefits and quite another thing to analyse whether the definition of residence is capable of excluding these entities from the scope of tax treaties. The interpreter must consider the manner in which the agreement of the parties as a whole sets up conditions for its application on the basis of the agreement itself. The definition of residence is crucial in that context insofar as it is this rule which, at the outset, leads to the elucidation of who should and who should not be entitled to treaty benefits and, in general, under which circumstances the application of the treaty would be valuable and appropriate.

10.2.3. Residence: The material scope of the treaty and the purpose behind it

Inasmuch as the function of a rule of treaty entitlement is to shed light on the personal scope of the agreement, and particularly since it describes the policy reasons which make treaty benefits desirable, in some way it also clarifies the range of issues the treaty is aimed at covering. In other words, by identifying the subject entitled to treaties the rule of residence elucidates, or at least should elucidate, the problems that the OECD MC is meant to solve, thus creating a fundamental representation of the object and purpose behind the agreement.

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832 Considering that the use of the Model may be sustained in cases of treaty shopping, the United States Model Tax Convention has in fact deviated essentially from the OECD MC in terms of including an extensive limitation-on-benefits rule so as to prevent its use in cases of treaty shopping, see Art.22 of the US MC.

833 FC/WP2(57)3, at pp.4-6.

834 Vogel, supra note 6, n.9, at p.223, and n.24a, at p.229.

835 Such as a limitation-on-benefits provision or a general anti-abuse rule.

Very few things can be more representative of the issues an agreement is meant to confront than the person entitled to its benefits. There is no clearer way to explain the purpose behind a treaty than to describe the circumstances under which a person will be granted the benefits contained in it. As a matter of fact, if in the text of a treaty no express mention were made in relation to the purpose it seeks, the identification of the subject entitled to its benefits would provide the interpreter with valuable elements for the determination of that purpose. By way of illustration, if under a certain agreement the person entitled to treaty benefits were any woman who suffers discrimination, one would reasonably conclude that the treaty is mainly oriented to oppose discrimination against women. If, in a different case, protection were offered to any person who suffers a disruption of his human rights, it would be safe to assume that, all in all, the agreement aims at countering human rights violations.

Answers do not come easily when the use of the term 'resident of a contracting State' in tax treaties is examined[836]. The broad meaning of the expression was supposed to respond to the need of harmonising the existent tax treaties at the time these instruments were first considered by the OEEC[837], but it is somewhat clear that the broadness of the definition is nowadays being problematic.

Considering that the definition of the person entitled to treaty benefits should be consciously set up by the parties in order to create a test that, having been passed, grants access to the integrity of the agreement, the adoption of the definition proposed by the OECD leads to difficulties. While the requirements imposed by the definition should respond to the policy objectives pursued by the parties, the OECD MC pursues several conflicting purposes. For instance, as has been stated few paragraphs before, on the one hand it seeks to exclude persons who are subject to taxation only on sources from a certain State[838], while at the same time not excluding residents of States applying a territorial system of taxation[839]. On the other hand, it recognises the need to exclude certain structures from tax treaty entitlement, such as conduit structures[840], while declaring that the Model does not set any standards for the domestic laws so as to give place to treaty residence[841].

If one considers the current issues in the field of tax treaties and particularly the circumstances in which these instruments are applied, it is evident that, from the perspective of the subject entitled to its benefits, neither the scope of the problems covered by the OECD MC, nor the precise object and purpose to which it aims, could unambiguously be stated. Hence, instead of acting as an element of judgement for a clear determination of the problems the agreement is meant to confront, the term 'resident' introduces several obstacles for an evaluation of whether the application of treaty benefits is appropriate in each case.

10.2.4. Unintended benefits and abuse from the perspective of residence

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836 According to van Weeghel and Gunn, unlike other treaties, the key function of tax treaties is "*not* to grant rights to an individual as such. Instead, the crux of the approach in tax treaties is the allocation of taxation rights between the two contracting States", see van Weeghel, supra note 600, at p.306.
837 C(55)307, at p.2.
838 Sec.8.2 of Comm. to Art.4 OECD MC.
839 Sec.8.3 of Comm. to Art.4 OECD MC.
840 Sec.8.2 of Comm. to Art.4 OECD MC.
841 Sec.8.2 of Comm. to Art.4 OECD MC.

From a treaty perspective[842], there is a general and rather uncertain principle according to which the benefits of a tax treaty should not be granted in unintended scenarios[843]. This debate is of utmost importance in the context of the discussion regarding profit shifting, treaty shopping and non-taxation. While the OECD has put significant efforts in explaining that treaty benefits in some of these cases may generically be tagged as unintended, improper, inappropriate or unduly obtained, very limited explanations have been given from the perspective of tax treaty entitlement, let alone from the perspective of the role played by the definition of residence[844]. Given the consequences it entails for the purposes of the interpretation of treaties, the analysis of the rule of residence seems to be crucial in this respect.

To refer to certain benefits as *unintended* is to use a heavily loaded adjective. According to its common meaning, the term suggests that the attribution of such benefits was not planned and, above all, not *meant*[845]. The ability to describe treaty benefits as unintended, however, requires the identification of the elements on the basis of which such qualification will be made. Seen from that perspective, the determination of whether the benefits of a treaty are unintended is, firstly, in close connection with the description of the treaty claimant. It is in respect of this person that the appropriateness of treaty benefits will be measured, each time a claim is raised. One may consider that the benefits of a tax treaty are generically unintended in cases of exemption, transparency or lack of substance, but all these apprehensions will only take form if a person that may be so characterised claims the benefits of the agreement.

The identification of the treaty claimant, however, represents only the first step. A point of reference is required for determining the inappropriateness of treaty benefits and therefore an element of judgment must be identified, in relation to which these benefits will be qualified in one way or the other. The relevance of the decision, nonetheless, requires the identification of an objective parameter, a standard to face this problem from a common perspective[846]. Inasmuch as it explains the conditions which lead to the conclusion of a tax treaty, and thus the essence of the policy reasons that make it desirable, a suitable candidate to perform this task would certainty be the underlying object and purpose of the agreement[847].

Tax treaty benefits may be labelled as unintended from the perspective of the rule of treaty entitlement if, given the particular circumstances of the treaty claimant, the request were based on the existence of a problem that does not match the scope of issues defined as relevant by the parties (the object and purpose of tax treaties). By way of illustration, this has traditionally been the manner in which the benefits of a treaty have been tagged as unintended in double non-taxation scenarios. Considering the purpose supposedly sought by the Model, namely the avoidance of double taxation, treaty benefits have been qualified as unintended given by the lack of consistency between the issue raised through the treaty claim (non-taxation) and the problems the agreement is allegedly meant to confront (only the avoidance of effective double taxation). There is a leap, however, in this line of reasoning, which is the commonly made assumption that

842 Regardless, in principle, of the presence of domestic rules dealing with the issue of abuse.
843 Sec.9.3 of Comm. to Art.1 OECD Model Convention (2014).
844 It is indeed interesting to notice that all the suggestions introduced by the OECD have been added to the Commentaries of Art.1 OECD MC, and not to those of Art.4 OECD MC, which defines residence.
845 Oxford Dictionary.
846 Van Weeghel, supra note 600, at pp.322-323. The main problem this entails is of course the definition of who sets this standard, see van Weeghel, supra note 133, at p.97. According to Maisto, these standards should be built on the basis of international law, see Maisto, supra note 611, at p.325.
847 Van Weeghel, supra note 133, at p.97.

the purpose of avoiding double taxation and double taxation only[848] has been properly portrayed in the Model.

If the OECD MC is observed from the perspective of the person entitled to its benefits, it is more or less evident that the object behind the agreement is rather unclear. Under those circumstances, the rise of tax treaty claims which seem to be out of the scope of the treaty from a policy perspective, but that are nonetheless technically 'legal', should not been striking. The depiction of the scope of the treaty through the rule of residence is inefficient, and therefore these claims are not only technically legal, but they cannot be said to be categorically out of scope either. Taking once more the example of a treaty the alleged purpose of which is to avoid double taxation only, if the definition of the subject entitled to its benefits aims in a different direction (namely to allow persons who are not taxed more than once on the same income), treaty claims will inexorably arise pleading for the application of treaties in scenarios of double non-taxation. Qualifying such benefits as plainly unintended would present quite a significant challenge.

When the issue of treaty abuse is analysed from this perspective, it appears that the OECD has followed a similar approach, and thus all the previous observations are equally applicable in this respect. According to the Commentaries to the Model:

> "[some States may] consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith"[849].

The alleged object and purpose of the Model has been used to put treaty benefits to the test in certain cases that appear to be artificial. In 2014 the OECD has quoted the Commentaries to the United Nations Model to propose that:

> "[…] the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty"[850].

Under this approach, a proper interpretation of tax treaties has, according to the OECD, enough merits to exclude abusive treaty claims. Yet the presence of abuse and thus an interpretation of treaties that may be qualified as *proper* seem to be defined in relation to the object and purpose of the agreement. Needless to say, the effective value of the statement drops significantly where the purpose of the Model is unclear[851]. This is particularly relevant for those who argue that treaties aim merely at the allocation of tax jurisdiction. Under such a premise, no matter how insubstantial the recognition of residence in a State may be, each State is, in principle, let free to make that decision on the basis of its sovereign power[852].

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848 Under this argument the Model should not operate in cases of double non-taxation.

849 Sec.9.3 of Comm. to Art.1 OECD Model Convention (2014).

850 OECD, Public Discussion Draft, supra note 27, at p.23.

851 Artificial strategies aimed at the recognition of treaty entitlement "encompass a broad spectrum of structures, ranging from the purely abusive and artificial ones to others with more substance. However, are all these instances of *improper* use of tax treaties?", see Avi-Yonah, supra note 749, at p.23.

852 If the laws of a State qualify a certain strategy of tax planning as legitimate, the chances of determining the presence of abuse decrease significantly as a circumvention to the law will be hard to demonstrate, see Vogel, supra note 6, at pp119-121, and the description of 'legitimate tax avoidance' in Nikolakakis, Angelo, 'Tax Law: Rules or Principles - Madness or Genius? Mind the Gaps!', in Baker, Philip, et al (eds.), *Tax Polymath: A life in international taxation*, (Amsterdam: IBFD, 2010), at pp.356-357.

If one takes the most well-known example of improper treaty entitlement, treaty shopping, a number of States would agree on the fact that its occurrence is not only harmless, but it may also be considered to generate favourable effects from a policy perspective[853]. While these States have used the OECD MC for decades to carry out this policy, paradoxically, other States need to be convinced, on the basis of the same rules, that they should refrain from granting the benefits of the OECD MC in scenarios of treaty shopping. This suggests that, in some manner, the lack of a precise definition in relation to the subject entitled[854] and its effects in identifying the purpose behind the agreement is quite relevant for the purposes of raising the debate in relation to tax treaty abuse[855].

While the issue of treaty abuse clearly raises not a legal question but a question of desirable tax treaty policy, the right elements need to be present in the Model in order to reach an interpretation capable of excluding abusive claims. It appears that the OECD has realised this, and in 2015 it has included a limitation-on-benefits rule and a general anti-avoidance provision[856] in the Model. While the effects of such additions in relation to all the remaining elements defining tax treaty entitlement in the OECD MC is yet to be explored, this is but a confirmation of what has been suggested earlier: when interpreting the Model, one cannot simply disregard its text and the policy that has been embedded into it as if it were not there. Double non-taxation may have evil consequences, treaty shopping may be unpleasant, but the Model, through its rule of treaty entitlement, seems to encourage their occurrence.

The debate at the heart of the issue of tax treaty abuse cannot be taken to a single answer through the interpretation of the Model, because the problem is not so much whether treaty benefits or the use of the OECD MC by certain persons would be unintended or improper. On the contrary, the problem lies in the determination of what improper or unintended means from the perspective of the rules pertaining the subject entitled to the benefits of the OECD MC.

10.3. Defining abuse under the definition of residence in Art.4 OECD MC

10.3.1. Introduction: An historical perspective

While it is relatively evident that the question of treaty abuse is deeply intertwined with the definition of residence, the OECD has chosen a very pragmatic manner of facing this issue from the perspective of the Model. The question is in fact commonly confronted by assuming the existence of a certain standard of conduct, of decency, perhaps, which allows the interpreter to decide whether a given tax planning scheme is acceptable or not. The issue of tax treaty abuse has been rarely explored by taking into consideration the elements provided by the Model itself.

As has been stated before, it appears that the definition of residence holds the key to determine which kind of behaviour is proper in the context of a treaty and, at the same time, whether the use

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853 In the words of van Weeghel: "does treaty shopping defeat fundamental and enduring expectations and policy objectives shared by both states? That question cannot be answered *in abstracto*. One will have to look at the expectations and policy objectives of the states that are parties to a particular tax treaty in order to answer that question", see Van Weeghel, supra note 133, at p.123.

854 Van Weeghel and Gunn have in fact identified the lack of a general legal framework to explain the cases of abuse, situation that results in an arbitrary determination of these cases, see supra note 600, at pp.322-323.

855 As Duff has pointed out: "to the extent that the object and purpose of tax treaties and specific treaty provisions are unclear, the application of an inherent anti-abuse principle is necessarily uncertain and difficult for courts to apply and taxpayers to follow", see Duff, supra note 157, at p.94.

856 OECD, Action 6: 2015 Final Report, supra note 1. The addition of a LOB rule to the Model was proposed by van Weeghel already in 1998, see van Weeghel, supra note 133, at p.259.

of a tax treaty is actually unintended or inappropriate. To analyse this question on the basis of the existing rules in present times may nevertheless be confusing, because the issue was irrelevant when the term 'resident' was originally defined[857]. By 1960, the elements at the core of Art.4 OECD MC were already defined[858]: The pertinence of a treaty claim was to be judged on the basis of the domestic laws of the different States. If the rules of those States allowed the creation of an entity to establish residence, the legitimacy of such strategies was not to be contended, or at least not from the perspective of the definition of residence.

In 1962, however, the United States Delegation raised a slightly different issue:

> "[…] in many cases the tax conventions have been employed for purposes other than the intended objective of eliminating double taxation, and have served as a means by which taxpayers avoid their proper tax burdens. Through the establishment of related corporations in several countries, *often for no purpose other than the anticipated tax benefits*, […] residents of non-treaty countries have been able to obtain the benefits of the conventions between two treaty countries by forming corporate entities in one or more treaty countries *for the sole purpose of obtaining such treaty benefits*. In both types of cases, *benefits are obtained which were never intended by the Contracting States* when the tax conventions were negotiated.
>
> […] In view of these fiscal and economic considerations, it seems appropriate for the Fiscal Committee to consider provisions for inclusion in income tax conventions so as to prevent the use of such conventions for avoidance of tax burdens (even though no violation of law may be involved), and to discourage the use of artificial transactions and corporate structures."[859]

The questionable character of these strategies, and therefore the meaning of abuse, was identified by the absence of any relevant substance in the creation of an entity and the main purpose of obtaining treaty benefits. From the time of this statement, the Delegation for the United States maintained a strong pressure on the OECD's agenda to consider alternatives to prevent the use of the Model in scenarios that appeared to be unacceptable. However, as the records of the different working groups involved with the issue at a later time show[860], instead of developing a conceptual framework to confront these situations, the OECD focused on the most notorious case of alleged abuse: base and conduit companies. The problem was defined under this pragmatic approach according to the peculiarities of these companies, and the crux of the conflict, namely, the absence of relevant substance, was somewhat lost. As a result of that, today it is quite a challenge to explain what abuse really means from the perspective of the Model itself.

10.3.2. The evil essence of abuse from an OECD MC's perspective

The purpose behind the exclusion of conduit companies proposed by the United States was given by the acts of a taxpayer who, although playing by the rules, artificially created an *alter ego*[861], that is, a separate tax liability, causing the application of a tax treaty that was not available to him directly. Because this tax liability was artificial, the benefits of the agreement, although availed of

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[857] "The Delegate for the Netherlands, […] expressed the view that the scope of the Conventions ought not to be limited to residents of Contracting States. […] The Chairman thought this question should be discussed later when the Committee was deciding whether to recommend the adoption of a multilateral Convention. He pointed out that there were various ways in which non-residents could avoid double taxation; *non-resident companies, for example, could create companies incorporated under the national law of the country in which they carried on business*", see FC/M(60)1, at p.8.

[858] FC/WP2(56)1, at p.3.

[859] Emphasis added. TFD/FC/136, at pp.1-2.

[860] Most of these records have been examined in Chapter 9, on the addition of a second sentence to Art.4 OECD MC.

[861] Wheeler, Joanna, 'The Attribution of Income to a Person for Tax Treaty Purposes', 59 *Bulletin for International Taxation* 11 (2005), at p.482.

according to the letter of the law, were nonetheless not *supposed* to be granted to this person. That was the heart of the issue of treaty abuse.

Following these lines, the OECD initially described the problem in very broad terms:

> 'What is finally to be understood by the expression "abusive application of a tax Convention" is not clear yet. It may be sufficient to say that this expression would seem to denote primarily cases where tax-payers make use of the provisions of a double taxation Convention in a way which is formally correct but which results in a given case in a total or partial loss of taxes for one or both Contracting States, not intended by the provisions.'[862]

Although in principle the absence of taxation seemed to be relevant, the description of the issue was later sharpened:

> "The question here discussed is an element of a far more comprehensive problem, namely the question of how a country may prevent taxpayers domiciled within its borders from avoiding tax by artificially placing their sources of income outside the boundaries of the country. [...]
>
> In this connection, abuse is not intended to refer to cases where, deliberately or not, the provisions of a convention have been applied improperly or have been ignored. Tax abuse for the purpose of this study is intended to include cases in which a person or a company obtains, by a correct application of the convention, *tax benefits that were not intended*."[863]

Further, the heart of the problem of base companies was defined very precisely:

> "[...] unlike the ordinary subsidiary company, [a base company] *does not engage in economic activities* in the country where it is established."[864]

One may easily observe that during the first years of debate, the core of the problem, namely the artificial character of the treaty claim raised in a conduit scenario, was quite accurately described. The lack of economic presence in the State in which treaty benefits were claimed, as in the case of BEPS today, was considered to be a good reason to deny those benefits. The concrete mechanism to exclude these companies from treaty benefits, however, was rather unclear.

In 1992, when the time came to apply all the knowledge acquired from discussing this issue for more than thirty years, the OECD decided not to be innovative. Instead of developing a general framework on treaty abuse, it tried to find a way to exclude conduit and base companies from the application of the Model on the basis of the existing rules. Of all the possible arguments targeted to materialise their exclusion[865], the OECD chose the one that they were not 'fully liable to tax':

> 'The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a "conduit company".
>
> > a) Article 4, paragraph 1, second sentence excludes from the term "resident of a contracting State" any person who is "liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein". [...] The commentaries on the 1977 OECD Model give as an example the case of certain diplomatic personnel. The provision would, however, apply according to its

862 Emphasis added. FC/WP14(62)4, at p.2.
863 Emphasis added. FC/WP21(63)1, at pp.1-2.
864 FC/WP21(63)1, at p.6.
865 Several options were explored to deal with the situation of conduits, such as: a) an increase of tax rates in the State in which the conduit was incorporated; b) changes in the corporate laws of the States to prevent conduit companies from being incorporated; c) excluding base companies from the definition of 'company' in tax treaties; and d) changes to domestic legislation in order not to recognise a conduit as a separate entity but more like a branch of its creator, see FC/WP21(63)1, at p.6.

> wording and spirit where, for example, foreign-held companies are *exempted from tax on their foreign income* [...]'[866].

Regardless of the many objections generated by the use of the second sentence of Art.4 OECD MC to deal with conduit structures[867], if one considers this new understanding of the rule of residence added to the Commentaries in 1992[868], it appears that the solution proposed by the OECD to the issue of abuse differs substantially from the original concerns raised in 1962. Under the primitive lines which gave place to this discussion, the artificial character of the measures taken to reach the sphere of a treaty or, perhaps more precisely, the capability of generating treaty entitlement despite the absence of any relevant substance, was identified as the core of the problem. While this situation is certainly akin to the case of base or conduit companies, it may also occur in several other scenarios[869]. The OECD not only restricted the scope of the discussion to that sole case. The reference to the income received by the conduit company and the tax regime this income was subject to was an unfortunate mistake. Under the final version of the Commentaries, these entities needed not to be considered as 'fully liable to tax', essentially because all of their foreign income was tax-exempt[870].

10.3.3. Defining abuse in the absence of 'full tax liability'

At some point in the history of the OECD MC the situation of the income received by the treaty claimant was described as relevant when determining the occurrence of treaty abuse. This deviation from the original definition of abuse may appear to be immaterial and yet, if one pays close attention to it, its effects are far-reaching. By bringing up the situation of the income received by a conduit company and its taxation, the OECD's position leaves the impression that treaty access should not be granted to such a company because there is no double taxation to be avoided. It appears, in other words, that the Model is being *abused* if its benefits are granted to a person that is not under the risk of effective double taxation, because for instance all his foreign income is tax-exempt, and not because of the lack of any relevant substance, which is really the heart of the problem. This is actually the reasoning behind the exclusion of conduit companies from the application of the Model in the Commentaries to Art.4 OECD MC today[871].

Further, this may be the reason why in 2008 the extension of this interpretation to residents of States losing a tie-breaker appeared to be so natural: After having lost a tie-breaker, a person could, depending on the laws of the State losing the tie, be taxed only on income from sources in that State. Considering that in such a case juridical double taxation would be unlikely to occur again, such a person had to be left outside the scope of any other tax treaties[872]. The exclusion of dual residents from the Model was not effected by the lack of an effective attachment between this person and the State in which the tie-breaker was lost. At best, one could say that the rules of the Model preferred the *strongest*[873] nexus in order to break the tie, yet this cannot necessarily mean

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866 The same reasoning is contained in OECD, Report on conduit companies, supra note 280, at p.10; and the Report on base companies, supra note 280, at p.17.
867 Examined in detail in Chapter 9.
868 See current Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).
869 The OECD recognised this in 1963, in cases of companies engaged in marketing, licensing of patent rights, furnishing or technical services, see FC/M(63)2, at p.4; and in 1969 in the case of personal services, see DAF/FC/69.13, at p.7.
870 The idea remains in Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014); Vann, supra note 41, at p.259.
871 Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014).
872 Sec.3 of Introduction to Comm. OECD Model Convention (2014).
873 FC/WP2(57)1, at p.5; Sec.5-7 of Comm. to Art.4 OECD Model Convention (2014).

that such a person had no economic relation whatsoever with the State in which the tie-breaker was lost[874]. The case, however, was explained as a case of abuse[875].

Although highly relevant in times in which double non-taxation produced by tax treaties is under public discussion, the manner in which the issue of abuse has been confronted is in open contradiction with some fundamental principles the very OECD has embedded in its Model Convention, explored in detail in other parts of this work. As has been said earlier, 'full' tax liability means nothing more than 'tax liability' alone. The adjectives 'full', 'comprehensive' or 'unlimited' are not meant to indicate that a certain tax base or tax rate is required[876], let alone that effective taxation bears any relevance for the purpose of tax liability[877].

Under its ordinary meaning, the existence of 'full tax liability' is identified by the fact that a person, in this case, a conduit company, possesses a personal attachment with a certain State that is capable of triggering the extension of that State's tax authority over the entity, regardless of whether that authority is in fact exercised or not[878]. On the contrary, 'limited tax liability' portrays a situation in which a State treats the treaty claimant as a non-resident (and therefore it extends its tax jurisdiction over the person not by virtue of its personal attributes, but only on the consideration of certain items of income it receives[879]). To contend that a situation of abuse would arise whenever a person's foreign income is tax-exempt contradicts one of the fundamental pillars of the OECD MC: the occurrence of effective double taxation is in no way a requirement for treaty entitlement to arise or to the OECD MC to operate, and double non-taxation is a natural effect of the policy behind the Model[880]. In practical terms, to characterise the use of the OECD MC as abusive because there is no risk of effective double taxation makes a response to the issue of treaty abuse from the perspective of the Model itself incoherent, if not impossible. The abuse of the OECD MC does not occur if a situation of non-taxation is provoked by its use, because the Model does not really care if that is the case. That, in fact, is not really the problem when the issue of treaty abuse is under analysis.

The solution to the issue of abuse from the perspective of the definition of residence is not focused on the absence of an economic nexus between the claimant and the State in which treaty benefits are claimed, because at the outset, under the rules of the Model, that is a question that needs to be answered by the domestic laws of such State[881].

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874 Sec.10 of Comm. to Art.4 OECD Model Convention (2014). If a person has a permanent home in one State and his centre of vital interests in the other State, the rules of the Model give preference to the former rather than the latter. In reality the person may continue to have his centre of vital interests in the State in which the tie-breaker was lost.

875 Russo, supra note 504, at p.465; Arnold, Brian, 'The 2008 Update of the OECD Model: An Introduction', in 63 *Bulletin for International Taxation* 5 (2009), at pp.178-179. The situation would be different if the establishment of a secondary residence in a given State is made with the view of obtaining the application of the tie-breaker to accomplish a certain tax avoidance result. In that case, the abuse, if it exists, would be given by the conduct of the taxpayer who purposely seeks to manipulate the provisions of the treaty. Yet this is a sensibly different case, in which the essence of the objection results from the creation of a tax liability in a secondary State that is fully artificial. In many cases of dual residence this is not the case, but it is impossible to make a distinction on the basis of the text of the Model.

876 See Chapter 7.

877 See Chapter 8.

878 See Chapter 6.

879 See supra Chapter7, at pp.81ff.

880 See Chapter 9, at pp.132ff.

881 And thus the answer to the question of abuse from this perspective is highly ineffective, see the analysis of Duff, on countering treaty shopping through the definition of 'liable to tax', Duff, supra note 157, at pp.81-84.

A sensibly different answer to the question of abuse would have been to acknowledge that tax liability, and therefore residence, was not something to be left completely to the laws of the States. The need for an economic nexus could have been imposed through the definition of residence by describing the meaning of 'liable to tax' at the treaty level, yet this would have required abandoning the idea that residence was a domestic issue[882]. Instead, the OECD pointed in the opposite direction. Although the issue of treaty abuse was properly raised from an historical perspective, the OECD deviated from the fundamental questions posed by it and this is why today, after more than fifty years of analysis, appropriate rules to deal with it are still being sought.

10.4. Residence: Political or economic allegiance?

Many questions arise from the manner in which the OECD has confronted the issue of treaty abuse from the perspective of the definition of residence, and perhaps the most basic of them refers to the reasons why the OECD's approach has failed. The reasons may be connected with the logic the term was sought to implement.

When the possibility of tax treaties was first explored by the League of Nations, four elements of economic allegiance[883] were identified so as to justify the submission of a person to a State's tax authority. Amongst those elements, source was defined as the place where the yield was physically or economically produced, and residence was described as the place where the wealth was spent, consumed, or disposed of[884]. The description of these elements was only meant to illustrate the diverse factors used by countries to justify their rules of taxation. The following debate on tax treaties was based on this discussion. From the times of the League of Nations, it has been assumed that residence represents an element of economic allegiance, and therefore the absence of residence has been equated to the absence of relevant substance. Nevertheless, when examining the expression 'liable to tax', it appears that it is one thing to sustain that residence portrays a criteria of economic allegiance, and quite another thing to sustain that the basic elements of residence, as defined in tax treaties, require the existence of an effective economic nexus for tax liability to arise.

It is important to keep in mind that the personal scope of the Model had to reconcile all the different rules through which the States applied their tax authority[885]. The role of Art.4 OECD MC as a model article required that ability. Yet persons were treated as residents around the world on the basis of the more diverse factors, some of them merely legal or, in a way, reasons that were generally far away from generating an effective economic nexus[886]. Criteria such as permanent home, habitual abode, incorporation, nationality, citizenship, or a stay of a certain length, were commonly included in the list of cases in which a person needed to be treated as a resident.

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882 Wheeler makes a similar observation in relation to the attribution of income: "The issue, however, is not whether domestic attribution rules are affected by treaties, but whether they should be affected by treaties. Undoubtedly, the attribution of income to a person should, as a basic principle, be left to domestic law [...]. But although domestic law is the foundation on which a treaty is built, the role of a treaty is to regulate the interface between the tax systems of two states. If the domestic laws of two states create an attribution mismatch, [...] a bilateral treaty [...] would seem the ideal forum in which to resolve the mismatch", Wheeler, supra note 861, at p.487.

883 LON, E.F.S.73.F.19, at pp.22[4026]-25[4029].

884 LON, E.F.S.73.F.19, at p.25[4029].

885 C(55)307, at p.2.

886 Dirkis identifies three groups of factors: firstly, those related to individual facts and circumstances, such as residence, domicile, permanent home, and others; secondly, those consisting in an arbitrary number of days; and finally, specific criteria such as citizenship, immigration status and engagement in government service or other related activity, see Dirkis, Michael, 'The expression "liable to tax by reason of his domicile, residence" under Article 4(1) of the OECD Model Convention', in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.140.

All these concepts used around the globe to describe a person's attachment to a State are nothing but fictions, and they are closer to portraying a political rather than an economic allegiance[887]. Even if one sustains that they do reflect a relation the essence of which is economic, it is relatively clear that they do not discriminate tax treaty claims that are based on thin air from those in which the economic substance is evident. The description of the attachment required for the Model to operate through these expressions is shallow and ambivalent: the ordinary meaning of 'liable to tax' defines a legal relation which, whatever its character, results in the tax authority of a given State being extended over a certain person. The essence of this ordinary meaning, once more, does not guarantee that the one factor that should be crucial for a decision on abusive tax treaty entitlement, namely the economic nexus between the treaty claimant and the State in which treaty benefits are claimed, would play any role for the purposes of such a decision. On the contrary, it is fairly clear that its presence is immaterial, unless the parties to a treaty decide to deviate from the Model in a way of paying attention to it[888].

10.5. Evaluation: The abuse of tax treaties under Art.4 OECD MC

There seems to be little reason to continue to argue that the various issues derived from the interpretation of the rule of residence should be faced exclusively from the perspective of attributing a meaning to the terms contained in it. In fact, it is relatively clear that, insofar as the basis on which tax treaty entitlement is granted are inconsistent from a policy perspective, there will be no interpretation capable of achieving a coherent application of the Model, despite the efforts of the OECD, authors and courts. The problems derived from the rule of residence are not to be explored exclusively from the perspective of its text, but on the contrary, by looking critically at the elements on the basis of which they have been construed.

The first element to keep in mind in this context is the function performed by the rule in shaping the application of tax treaties according to the intention of the parties. One needs to understand that this rule not only describes the problem that the agreement is meant to solve and therefore its object and purpose, but also, and more fundamentally, it sets out the cases in which the application of its benefits may be qualified as reasonable or intended. By setting up such a crucial rule, the States take the first step in materialising the different policy objectives defined as valuable by them from the perspective of their own situation, at the same time describing the issues that make the application of the treaty desirable and undesirable from their perspective.

Taking into consideration that the issue of treaty abuse has been discussed for over fifty years, it is rather striking that the problem has not been faced from this perspective. In the current context, the primary mission of residence is not to be inclusive, but mostly to be capable of excluding certain treaty claims and to set up barriers or filters to tax treaty entitlement. The inconsistencies at the core of the rule of residence appear to be crucial to guarantee the endless character of the debate in relation to tax treaty abuse, or in respect of the qualification of treaty benefits as unintended, improper, or inappropriate. At the outset, failure to provide an answer to the question of whether tax treaty benefits are being claimed in an abusive manner seems to derive from a fundamental flaw, which is the uncertainty as to the policy objectives pursued by the OECD MC. It is nowadays commonly understood that not any domestic resident should be able to access the benefits of tax treaties. Yet, it is the lack of clarity in relation to this essential element which prevents from knowing with enough certainty where the boundaries are that need to be trespassed for an abusive or improper use of a tax treaty to arise.

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887 The link is based on legal forms rather than on economic presence, Sadiq, supra note 162, at p.173.

888 By way of illustration, introducing a limitation-on-benefits clause or any other rule of that kind.

Further, one needs to keep in mind that the question of whether the definition of residence should deal with the issue of abuse and how is nevertheless different than the question of whether Art.4 OECD MC has the appropriate means to do so. From an historical perspective, the OECD rightly defined the issue of abuse as the lack of relevant substance when raising a tax treaty claim. Sadly, at some point during the debate the OECD deviated from the original scope of the problem, and decided to confront the issue of treaty abuse by focusing on the determination of whether the treaty claimant was subject to 'full tax liability'.

This approach is condemned to failure. Firstly, because 'full tax liability' means nothing more that a tax liability that is based on personal attributes, and not exclusively on income arising from sources in a given State. Secondly, because the absence of full tax liability has been identified by the OECD in the case of persons enjoying partial exemptions (foreign income), in circumstances that the Model recognises treaty entitlement in cases of full exemptions. The conception of treaty abuse under the OECD's approach in fact contradicts one of the fundamental pillars of the OECD MC, which is that effective taxation (or the lack of it) are irrelevant when making a decision on a person's tax treaty entitlement. In that sense, it is fairly obvious that the question as to the improper treaty entitlement of a conduit company, exclusively under Art.4 OECD MC, would not lead to a unique answer. The definition of residence is, under the approach followed by the OECD, incapable of confronting the question of abuse.

Rounding up the different considerations that have been explored across the length of this study, it is relatively clear that the ordinary meaning of the term 'liable to tax' refers to a connection of authority between a person and a State. That link is defined by the laws of the State in which residence is claimed as broadly as possible, with no reference to the income received and, in principle, to certain levels of economic connection. All that the ordinary meaning of the term 'liable to tax' requires is that the laws of a State set up a scene where a person is subject to the tax authority of that State in a general, permanent and abstract manner. Whether that State applies a certain principle of taxation, such as the worldwide or the territorial systems[889], or if it imposes certain taxes different to those mentioned in Art.2 OECD MC, is in fact irrelevant. It is also immaterial whether the relation is based on actual facts or on a legal fiction, as in the case of diplomats or in cases of extended tax liability. The term 'liable to tax' is defined almost as an attribute of personality, and it portrays a link that is more political than economic. This has tremendous consequences for the conceptualisation of tax treaty abuse.

It is therefore stated that, in principle, if the States do not wish to add further rules to tax treaties in order to deal with treaty abuse (such as limitation-on-benefits provisions or general anti-abuse rules), they should take measures to clarify their position in relation to the purpose their pursue, and to structure their definition of residence in line with that purpose. Whether they are willing to tolerate treaty shopping or double non-taxation are aspects which need to be expressly dealt with in the text of the treaty. This is particularly relevant if one considers that the appropriateness of the means used to obtain treaty entitlement, as much as the presence of abuse, must be evaluated not in the abstract but on the basis of the specific agreement of the parties[890]. By doing so, they will attack the root of the problem, thereby reducing the possibilities of later conflicts in the field of the interpretation and application of their tax treaties.

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889 Sec.8.3 of Comm. to Art.4 OECD Model Convention (2014).

890 In line with this conclusion, see Vogel, supra note 6, n.81, at p.118; Bammens, supra note 292, at p.57. This has also been recognised by the United Nations also, see Baker, Philip, 'Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion', in *Papers on Selected Topics in Administration of Tax Treaties for Developing Countries*, (New York, loose-leaf, 2013), at p.6.

11. Chapter 11

Treaty abuse under the updated version of the OECD MC: The effect of adding a general anti-abuse and a limitation-on-benefits provision on the ordinary meaning of 'liable to tax'

11.1. Introduction

In previous sections of this work the ordinary meaning of the term 'liable to tax' has been explored in its context, and in light of the object and purpose of the OECD MC. In broad terms, the idea has been proposed that the term 'liable to tax' describes no more than a connection between the claimant and the State in which the treaty claim is raised that is ultimately based on those laws, and the essence of which is more political than economic.

The use of tax treaties in cases of profit shifting, however, begs for the question of whether an effective economic nexus may be required from the perspective of the Model itself, regardless of the opinion one may have in relation to the *ugliness* of treaty abuse. As has been suggested repeatedly across this study, the fundamental flaw behind the OECD's approach in this field seems to lie in the assumption that there is something obvious about the meaning of 'abuse' for treaty purposes, namely the need for economic substance. The reality of the Model is nonetheless other. Nothing seems to be obvious in relation to treaty abuse, particularly if one analyses its existence by taking into consideration the definition of residence in the OECD MC.

In fact, after decades of studying this issue the OECD has come to the conclusion that some rules need to be added to the Model in order to fortify its structure against cases of abuse: A new limitation-on-benefits (LOB) provision and a general anti-abuse rule (GAAR). Bearing in mind that these clauses aim at restricting tax treaty entitlement, one cannot but wonder whether they may have an influence on the process of attributing its ordinary meaning to the term 'liable to tax'. After all, it is this notion, at the core of the definition of residence, which defines the kind of nexus a person must have with a certain State in order to successfully claim treaty benefits.

Accordingly, this section will explore the addition of a general anti-abuse rule and a limitation-on-benefits provision to the OECD MC. The purpose of this analysis is not to define 'abuse' as an abstract notion, but to discuss whether these new rules will re-define abusive tax treaty entitlement by influencing the attribution of its ordinary meaning to the term 'liable to tax'. In other words, this part will discuss whether the proposed additions will have an effect on the meaning of residence and, in that particular manner, on the interpretation of tax treaties in general.

11.2. BEPS and a new OECD's approach on artificial treaty entitlement

11.2.1. Introduction

The renewed interest in the issue of tax avoidance at the international level has resulted in the necessity to coordinate every attempt to deal with it. According to the OECD, any unilateral actions by the States must be avoided because they pose a threat of double or even multiple taxation[891]. There is clarity on the fact that something needs to be done to confront the issue of treaty abuse, and yet it appears that the final goal of the BEPS project is rather unclear. The initiative was triggered by the public outrage provoked by the case of many multinational

[891] OECD, Addressing BEPS, supra note 27, at p.50.

companies which, despite their huge profits, managed to pay little or no tax in their respective jurisdictions. In that context, one may expect that the measures proposed will be of a magnitude capable of shaking the foundations of tax treaties. More specifically, one cannot but hope that the threshold for tax liability would be raised in order to grant treaty benefits in fewer cases. However, whether these measures actually have an effect on the ordinary meaning of the term 'liable to tax' is not an easy question. On the one hand, the answer to this question is given by the scope of the BEPS project and, on the other hand, by the nature of the rules proposed in order to achieve its purpose.

11.2.2. Base erosion, profit shifting and restrictions to tax treaty entitlement

11.2.2.1. The true scope of BEPS

By way of introduction to this section, some observations may be made in relation to certain myths and realities behind the BEPS initiative. Firstly, the OECD has tried to present profit shifting as a current international concern, while this is actually not true. The issue of tax avoidance through profit shifting has been discussed for over fifty years[892] and so far none of the solutions proposed by the OECD has been effective enough to solve it. Secondly, the OECD has maintained an ambiguous speech in relation to the purpose behind the initiative. On the one hand, it declares that it seeks to restore the balance between domestic and international investment[893] and, on the other hand, it implies that one of the main goals behind it is to solve the problem of double non-taxation[894]. However, a detailed analysis of the project demonstrates that both statements, although sincere in a general manner, are nonetheless far from being accurate[895].

There are two types of profit shifting: one that is 'good', namely one that responds to at least a certain degree of economic reality, and one that is 'bad', characterised by the complete absence of any economic substance[896]. In the specific area of tax treaty entitlement the project deals only with the latter[897]. Any double non-taxation caused by 'good BEPS', along with any distortions in the balance between domestic and international investment caused by it, are outside the scope of

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892 It was raised for the first time in 1962, see TFD/FC/136.

893 OECD, Addressing BEPS, supra note 27, at p.50.

894 OECD, Addressing BEPS, supra note 27, at p.10.

895 By way of illustration, the scope of the problem of non-taxation is in fact quite restricted: "[n]o or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it", see OECD, Action Plan, supra note 27, at p.10.

896 For a distinction between good BEPS and bad BEPS, see the Action Plan, supra note 27, at pp.13-26. Although one may argue that the project is also meant to confront situations that are not necessarily artificial (as in the case of hybrid mismatch arrangements, see OECD, Action Plan, supra note 27, at pp.15-16), it is somewhat clear that the heart of the BEPS initiative, at least in the matter of access to tax treaties, lies in the distinction between those cases in which the absence of an economic nexus is manifest, and those situations in which some relevant substance can be said to exist. The distinction between 'good BEPS' and 'bad BEPS' is therefore relevant inasmuch as it suggests that the problem, as defined by the OECD, lies in the artificial nature of the arrangements entered into with the view of obtaining treaty benefits, and not necessarily in the reduced taxation achieved by those means. It also suggests that the OECD's intention to restore the balance between domestic and international investment is not as comprehensive as one would have expected. In spite of the broad terms that launched the subject of BEPS straight to the top of the list of international concerns, its scope is primarily restricted to cases of 'bad BEPS'. Generally speaking, any asymmetries or comparative advantages derived from a cross-border setting are not covered by the BEPS initiative if they do not entail a wholly artificial segregation of income from its source. Those asymmetries, if they are not artificial, have been accepted as a factor of competiveness, see OECD, Addressing BEPS, supra note 27, at p.28.

897 Except perhaps in the field of hybrid mismatch arrangements, where the OECD has stated that the purpose of the measures proposed should aim at solving disparities between domestic legislations, which facilitate the erosion of the tax base. Some of the scenarios described, such as double deductions and long-term deferrals, for instance, do not exclusively refer to artificial structures, see OECD, Public Discussion Draft, supra note 500, at pp.15-16.

the initiative. While the discussion regarding BEPS suggests the need of some important changes to the determination of the subject entitled to tax treaties, its effects in the area of tax treaty interpretation in general should be, as a matter of fact, somewhat restricted.

11.2.2.2. The problem of BEPS is one of means and not of results

Another thing that is relevant about the issue of profit shifting as defined by the OECD is that this is a problem of means and not of results. As was stated earlier in previous sections of this work, it appears that when the meaning of treaty abuse was first described, the fact that a person was able to escape taxation was relevant. Yet this was clearly not the core of the issue. In the context of BEPS the erosion of the tax base is not in itself a problem, unless the means used to do so are fully artificial[898].

If profit shifting results in double non-taxation this is not really a problem, provided that the relevant business structure responds to at least some degree of economic substance[899]. These strategies only become questionable if there is not even a hint of economic reality behind them, something that was defined previously as 'bad BEPS'. One needs to realise that if any restrictions to tax treaty entitlement are proposed in the context of the BEPS initiative, they will be restricted to this problem and this problem alone[900]. They will not aim to change the essence of the OECD MC, but only to regulate the case of certain taxpayers who, in the absence of an economic nexus with a certain State, are nonetheless authorised to make use of its tax treaties. In a Model Convention where the levels of taxation bear no influence for the purposes of tax treaty entitlement, the situation could not have been different. All these aspects are fundamental if the effect of adding a general anti-abuse rule and a limitation-on-benefits provision on the ordinary meaning of 'liable to tax' is to be analysed.

11.2.3. A general anti-abuse rule in the OECD MC

11.2.3.1. Introduction

The March 2014 Public Discussion Draft on "BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances"[901] introduced a proposal for a new general anti-abuse rule. This draft rule was perfected by the September 2014 Deliverable, and was published in October 2015 as the final version of the new GAAR to be added to the Model:

> "Notwithstanding the other provisions of this Convention, *a benefit* under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention"[902].

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898 OECD, Addressing BEPS, supra note 27, at p.28.

899 "No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it", see Action Plan, supra note 27, at p.10.

900 OECD, Public Discussion Draft, supra note 27, at p.27

901 OECD, Public Discussion Draft, supra note 27.

902 Emphasis added. The September 2014 Deliverable added the mention to 'capital' and changed the word 'main' for 'principal' when referring to the purpose of the arrangements, see OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. Action 6: 2014 Deliverable*, (Paris: loose-leaf, September 2014), at p.66; and the previous version of the proposed rule in OECD, supra note 27, at p.10. No more additions or changes were introduced to the final version of the rule, see OECD, Action 6: 2015 Final Report, supra note 1, at p.55.

There are several aspects of this new rule which touch upon sensible areas of the definition of residence in Art.4 OECD MC.

11.2.3.2. A benefit shall not be granted in respect of an item of income

This is perhaps the most relevant part of the proposed provision for the purposes of Art.4 OECD MC. As an effect of the application of the new rule, access to the OECD MC will be denied only in relation to the *item of income* in respect of which a treaty *benefit* is requested. In other words, this means that the proposed rule does not engage directly with the provisions dealing with the characterisation of a person as a 'resident' under Art.4 OECD MC, or at least not in terms of denying that status under the rules of the Model. In principle, the term 'resident' will continue to be defined under the provisions of Art.4 OECD MC exclusively, and it will not be altered by the existence of this anti-abuse regulation. This suggests that an artificial arrangement which gives place to a tax liability, capable of triggering the application of the Model (by way of establishing residence), should find no opposition in this rule, or at least not in a way in which the person needs not to be considered a resident for treaty purposes permanently.

This limited scope of the rule is nonetheless consistent with its purpose, which is restricted to oppose certain abusive acts beyond the boundaries of the limitation-on-benefits rule, specifically in the case of conduit financing arrangements[903]. Notwithstanding the need to verify whether the arrangements or transactions giving place to the establishment of residence are artificial, discussed in a subsequent part of this section[904], the new rule does not alter the core of the definition of residence for the purposes of the Model.

11.2.3.3. The benefit was *one of the principal purposes* of the arrangements

There is really nothing original in this statement, except for the fact that it will be moved from the Commentaries to the Model[905]. Under the current version of the Commentaries:

> "[…] the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position […]"[906]

According to the new 2015 final version of the Commentaries to the rule:

> "The provision is intended to ensure that tax conventions apply in accordance with *the purpose for which they were entered into*, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose main objective is to secure a more favourable tax treatment."[907]

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903 OECD, Action 6: 2014 Deliverable, supra note 902, at p.11 and at p.67; OECD, Action 6: 2015 Final Report, supra note 1, at p.19.

904 This will be further discussed at pp.171ff.

905 OECD, Action 6: 2014 Deliverable, supra note 902, at p.66. Russo suggested that moving certain elements from the Commentaries to the Model would reduce the time spent in these discussions, see Russo, supra note 504, at p.565.

906 Sec.9.5 of Comm. to Art.1 OECD Model Convention (2014). See Engelen, supra note 600, at p.31; van Weeghel, supra note 600, at pp.322-323. According to the OECD, '[t]he reference to "one of the principal purposes" in paragraph 7 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit', see OECD, Action 6: 2015 Final Report, supra note 1, at p.58.

907 Emphasis added. OECD, Public Discussion Draft, supra note 27, at p.11; OECD, Action 6: 2015 Final Report, supra note 1, at p.56.

From the drafting of the provision, it is clear that the description of cases of abuse will be strongly determined by the definition of the object and purpose behind the OECD MC. A particularly broad mention has been made of the purpose of facilitating cross-border trade and investment through bona-fide transactions, which is one of the many goals pursued by the OECD MC[908]. Yet, as has been stated in previous parts of this study, the determination of the object and purpose behind the Model is rather unclear precisely because the OECD MC needs to act as a model treaty[909] in a variety of scenarios. Instead of the States adapting to the rules of the OECD MC, as if they constituted a second-level social contract[910], it is the rules of the Model that need to adapt to any tax system, and to the wishes of States implementing different and sometimes conflicting policy objectives, such as capital-import and capital-export neutrality. To submit the applicability of an anti-abuse clause to the determination of this object and purpose evidently threatens the efficacy of the rule, but then again, what the States define as relevant from a policy point of view when negotiating a treaty is their own responsibility.

11.2.3.4. The arrangements resulted *directly or indirectly* in an advantage

The broad reference to arrangements which result *directly or indirectly* in abusive treaty benefits raises the question of whether the establishment of residence may be considered between those arrangements. According to the 2014 Discussion Draft:

> 'The phrase "that resulted directly or indirectly in that benefit" is deliberately broad and is intended to include situations where the person who claims the application of the benefits under a tax treaty may do so with respect to a transaction that is not the one that was undertaken for one of the main purposes of obtaining that treaty benefit. [...]
>
> The terms "arrangement or transaction" should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. [...] These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, *including the qualification of that person as a resident* of one of the Contracting States, and *include steps that persons may take themselves in order to establish residence*.'[911]

It is rather evident that, when confronting a case of treaty abuse, the means used to obtain treaty protection had to be subject to scrutiny. The acts of a taxpayer which are of significance in order to establish residence are thus within those factors that need to be considered in order to determine the presence of abuse under the new rule. However, as was stated before, there is nothing in this provision which alters the characterisation of the claimant as a resident of one of the States beyond the situation of the *item of income* for which the claim is raised[912]. Moreover, that scope is further restrained by the presence of a crucial exception linked to the object and purpose pursued by the agreement.

11.2.3.5. Exception: The *object and purpose* of the relevant provisions

The application of the general anti-abuse provision in order to contend with cases of alleged abuse is subject to a crucial exception explained by the OECD:

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908 Which is already present in Sec.7 of Comm. to Art.1 OECD Model Convention (2014).
909 See Chapter 9, at pp.145ff.
910 Christians, supra note 85, at p.133.
911 OECD, Public Discussion Draft, supra note 27, at pp.11-12; OECD, Action 6: 2015 Final Report, supra note 1, at p.57.
912 The OECD has sought to safeguard the use of the Model in cases of abuse both from the perspective of the relevant income (general anti-abuse rule) and from the perspective of the relevant taxpayer (limitation-on-benefits rule), see OECD, Action 6: 2014 Deliverable, supra note 902, at p.11 and at p.67.

> "[…] the last part of the paragraph allows the person to whom the benefit would otherwise be denied [under the general anti-abuse rule] the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."[913]

In plain terms, the rule leaves space for the argument that the application of the Model cannot be denied, even in cases that may be allegedly abusive, if the object and purpose behind the relevant provision supports its operation. Bearing in mind that the different purposes pursued by the States form part of what has been broadly described as the purpose of the Model in the singular[914], it is relatively clear that, by using this object and purpose as an excuse, the application of the general anti-abuse rule could be threatened[915]. It all depends on what can be defined as 'abuse' on the basis of the object and purpose pursued by the contracting States in each case[916].

This problem as been expressly recognised by the OECD:

> "[…] the purpose of an arrangement or transaction is a question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case by case basis"[917].

The object and purpose of a tax treaty is nothing more than the crystallisation of all the different policy objectives the parties pursue by entering into tax treaties[918]. In that sense, to incentivise treaty shopping may form part of a State's strategy to stimulate foreign investment[919]. If that were the case, the object and purpose of that treaty would clearly contemplate the use of its benefits in circumstances of treaty shopping, and yet one is led to believe that such a situation should be plainly excluded from the application of the Model as *abusive*[920]. This is at least a peculiar reasoning, considering that the Model has long been used by countries like India, which has explicitly recognised the benefits of treaty shopping and promoted its occurrence by applying treaties that are essentially similar to the OECD MC[921]. The convenience of treaty shopping has

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913 OECD, Public Discussion Draft, supra note 27, at p.10; OECD, Action 6: 2015 Final Report, supra note 1, at p.55.

914 See supra Chapter 9, at pp.133ff.

915 Arnold described the *need to prevent tax avoidance* as a purpose of tax treaties in the context of the 2003 additions to Commentaries as "vague", see Arnold, supra note 775, at p.247.

916 Bammens, supra note 292, at p.57.

917 OECD, Public Discussion Draft, supra note 27, at p.12; OECD, Action 6: 2015 Final Report, supra note 1, at p.57.

918 Supra, Chapter 9, at pp.135ff.

919 Because "in the end each Contracting State sets its own policy", see de Broe, supra note 496, at p.348. This, despite the fact that under the Commentaries to the new GAAR, because when reading this rule "in the context of the rest of the Convention and, in particular, its preamble, [it] cannot be considered as having the purpose, shared by the two Contracting States, of authorising treaty-shopping transactions entered into by public companies", see OECD, Action 6: 2015 Final Report, supra note 1, at p.56.

920 After having exemplified the case of a conduit financing arrangement, the new Commentaries to the Model state: "In that case, paragraph 7 would apply to deny that benefit because subparagraph 2 c), when read in the context of the rest of the Convention and, in particular, its preamble, cannot be considered as having the purpose, shared by the two Contracting States, of authorising treaty-shopping transactions entered into by public companies", see OECD, Action 6: 2015 Final Report, supra note 1, at p.56. One cannot ignore the fact, however, that there is not even clarity as to the meaning of the expression 'treaty shopping'. Avi-Jonah has noticed that 'the term "treaty shopping" has never featured in any versions of the OECD Model. Nor has it been properly defined or explained in the OECD Commentary. Rather, the emphasis is always on eliminating treaty shopping', see Avi-Jonah, supra note 749, at p.22.

921 India, *Azadi* Bachao *Andolan*. supra note 25. This seems to be coherent with the idea that the simpler the use of a treaty the more incentives for FDI, see Barthel, supra note 733, at p.7. In relation to India, however, it is interesting to notice that the Supreme Court ruling in *Vodafone* has resulted in the proposal of GAAR in 2013. The ruling in *Vodafone* was focused on an indirect transfer of property leading to the absence of withholding tax on the capital gain arising in India. Although India's propensity to accept treaty shopping may be threatened on the basis of this ruling, it is interesting to notice that the Supreme Court overturned most of the arguments held by the High Court of Bombay when analysing the business connection between Vodafone and India. In fact, it accepted the argument that, because of the structure had been operating for years without being challenged by the tax authorities, that was a sign that it was not necessarily abusive, see Lampreave, Patricia, 'Anti-Tax Avoidance Measures in China and India: An Evaluation of Specific Court Decisions', in 1 *Bulletin for International Taxation* 67 (2013), at pp.56-59. As a matter

even been sustained on the basis of some European well-known case law[922]. It should therefore not be surprising that to some judges treaty shopping is not inherently questionable[923], and the expression is not necessarily a *dirty word*[924]. Abuse seems to be, after all, "in the eye of the beholder"[925].

It appears that the determination of the object and purpose of the OECD MC is one of those aspects, such as the conceptualisation of 'abuse' in the abstract, in which many things are just taken for granted. On the contrary, one needs to keep in mind that the determination of the object and purpose behind a tax treaty or its provisions is given by the legitimate expectations shared by the States when conducting their negotiation. If they both intend to carry out a simple allocation of tax jurisdiction, to agree to tax treaty entitlement based on mere incorporation, or even to promote treaty shopping, the effectiveness of the general anti-abuse rule will be severely undermined. While it is true that the benefits of a treaty should not be granted in cases of abuse, there would be no abuse, in the first place, if the treaty claimant adapts to what the parties have defined as relevant from a policy perspective in their agreement. The OECD MC has been designed in a way in which its object and purpose is obscure, adaptable and conveniently flexible, and yet this is not a coincidence but a very careful decision. There is the need to promote its use by a number of States pursuing a variety of objectives. To submit the efficacy of its anti-abuse provision to those definitions and to expect that the application of the rule will be peaceful may simply be too much to ask[926].

11.2.3.6. Evaluation: The anti-abuse rule as a *de facto* test of residence?

Despite the fact that the effects of the general anti-abuse rule are limited to the benefits associated to particular flows of income for which treaty protection is invoked, the manner in which the rule

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of fact, experts do not unanimously agree on the negative aspects of treaty shopping, see de Broe, Luc, et al., 'Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions', 65 *Bulletin for International Taxation* 7 (2011). In particular, see the comparison between US policy and Indian policy regarding the convenience of treaty shopping, and the positions of Canadian and French courts on that matter. Further, there are cases in which the lack of action against treaty shopping is taken to signify a certain acquiescence or approval of its occurrence from a policy perspective, see the case of Brazil in Freitas de Moraes e Castro, Leonardo, 'Brazil's Anti-Treaty Shopping Measures: Current and Future Developments regarding Beneficial Ownership and Limitation on Benefits Clauses in Tax Treaties', in 65 *Bulletin for International Taxation* 12 (2011), at p.673.

922 Calejo Guerra examines certain ECJ rulings to suggest some sort of acceptance of treaty shopping at the European Union level, see Calejo Guerra, José, 'Limitation on Benefits Clauses and EU Law', in 51 *European Taxation* 2/3 (2011), at pp.89-96 and, in particular, the analysis of the *Cadbury Schweppes* and the *Saint-Gobain* cases at p.93. He also concludes that there is a certain incompatibility between the use of LOB provisions and EU law, an idea shared by Hofland, Dick and Pötgens, Frank, 'Netherlands/Japan. The LOB Provision in the New Japan-Netherlands Tax Treaty', in 51 *European Taxation* 5 (2011), at pp.215-220.

923 Van Weeghel and de Boer's analyse some *Hoge Raad* case law on the application of the *fraus legis* doctrine, according to which "the object and purpose of a tax treaty are frustrated only if there is a sudden change in the ownership structure and dividends are diverted according to predetermined steps so as to avoid tax". Treaty shopping, as such, is not necessarily vulnerable to substance-over-form doctrines, see van Weeghel, Stef; de Boer, Reinout, 'Anti-Abuse Measures and the Application of Tax Treaties in the Netherlands', in 60 *Bulletin for International Taxation* 8 (2006), at pp.360-364. Avi-Jonah has also examined in detail the theoretical objections to treaty shopping, see Avi-Jonah, supra note 749, at p.22, and at pp.25-30; and also Nikolakakis has explored the boundaries of what he calls "legitimate tax avoidance", see Nikolakakis, supra note 852, at pp.356-358.

924 Kandev discusses treaty shopping from the perspective of Canadian case law favourable to the taxpayer, see Kandev, Michael, 'Treaty Shopping in Canada: The Door is (Still) Open', in 62 *Bulletin for International Taxation* 10 (2008), at p.463.

925 Blessing, Peter, 'Limitation on Benefits as Applicable to Commercial Entities Under the Canada-US Income Tax Treaty', in Maisto, G., et al. (eds.), *Essays on Tax Treaties: A Tribute to David A. Ward*, (Amsterdam: IBFD, 2012), at p.254.

926 Duff arrives to a similar conclusion when discussing the presence of an inherent anti-abuse principle in tax treaties, see Duff, supra note 157, at p.94.

has been built takes care of the definition of residence being too broad. The provision introduces a test according to which the material dimension of the transactions entered into with the view of accessing treaties turns out to be questionable. These artificial arrangements, amongst them, the ones related to the establishment of residence, are to be subject to scrutiny if they are executed with the principal purpose of obtaining treaty benefits that are unavailable directly.

The question of whether some restrictions are imposed on the matter of tax treaty entitlement, which is clearly answered in the affirmative, is nonetheless different from the question of whether the addition of this new rule affects the attribution of its meaning to the term 'liable to tax'. In principle, a person will continue to be subject to the Model if his tax liability can be verified from a domestic perspective. The rule is not meant to alter this basic definition.

Regardless of the fact that the general anti-abuse rule does not engage directly with the provisions of the Model dealing with residence, it appears that, in practice, this rule may actually have such an effect. If, by way of illustration, the tax authorities of a State successfully challenge the creation of a company because of the artificial character of the measures taken to establish its tax liability, doubtlessly they will continue to invoke that argument to deny every future treaty claim raised by such company. Arguably, this may result in a *de facto* denial of its characterisation as a resident of that State for treaty purposes. This is why the question of whether the addition of a general anti-abuse rule affects the definition of residence is not immaterial. It may be argued that a company that is subject to scrutiny under the new rule must not only to be 'liable to tax' by reason of residence, domicile, place of management or any other similar criterion in a given State. On the contrary, the tax liability of such a company needs to be determined by reason of an effective economic attachment with that State (whatever that means), because the possibility of denying treaty access if the claim is based on thin air actually exists.

It is nonetheless clear that this is not the spirit the OECD has sought to embed in its Model through this rule. The absence of any comments on the situation of Art.4 OECD MC and on the Commentaries to the rule defining residence as an exclusively domestic concern reveal that the purpose of the GAAR is not to get involved in those fundamental definitions. The rule seeks to set out a different requirement or an additional barrier for residents in order to reach the protection of the Model[927]. Although the elevation of the threshold for tax liability in terms of requiring a minimum standard of economic presence would have been an interesting way of facing abuse, being pragmatic, as the OECD tends to be, the rule may be effective enough in solving the part of the problem related to the income for which protection is invoked. The subjective part of the problem, namely, the focus on the personal characteristics of the relevant taxpayer and its characterisation as a person entitled to treaty benefits, is confronted through a different rule.

11.2.4. A *brand new*[928] limitation-on-benefits provision in the OECD MC

11.2.4.1. Introduction

The March 2014 Public Discussion Draft[929] introduced a proposal for a LOB rule, modified by the September 2014 Deliverable and the October 2015 Final Report[930] on the matter. Under the new version of the Model, the States wishing to use the Model have two alternative provisions:

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927 For instance, the beneficial ownership requirement in Arts.10 and 11 of the OECD Model Convention (2014).

928 The LOB rule was already present in the Commentaries but only as an alternative provision, see Sec.20 of Comm. to Art.1 OECD Model Convention (2014).

929 OECD, Public Discussion Draft, supra note 27.

'Simplified version
1. Except as otherwise provided in this Article, a resident of a Contracting State shall be entitled to the benefits that would otherwise be accorded by this Convention only if such resident is a qualified person.

Detailed version
1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.'[931]

The many responses and interpretations the public discussion draft generated, coincide on one thing: the rule clearly seeks to deal with the issue of treaty abuse by raising the threshold for a person to be granted access to the benefits of the Model[932]. Considering this purpose, the inclusion

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930 OECD, Action 6: 2014 Deliverable, supra note 902. From March to September 2014 the rule suffered many changes. One of them was the reference to "the benefits" of the Model, which was changed to "a benefit" under the September drafting. Under the rule proposed in March 2014: 'A resident of a Contracting State shall not be entitled to *the benefits* of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2.' The October 2015 Final Report introduced drastic changes to the rule, as it is explained in detail in this section.

931 Under the September 2014 version of the rule: 'Except as otherwise provided in this Article, a resident of a Contracting State *shall not be entitled to a benefit* that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded'. The October 2015 version replaces this rule, and introduces two versions of the article: a simplified one and a detailed one. This implies that the rule is drafted in a way in which the States may select the text of the relevant paragraphs of the article, and also the relevant Commentaries they wish to use. It is relevant to bear in mind that, as the OECD has acknowledged, this draft rule is subject to modifications during 2016, once the work of the United States on its LOB model rule has been completed, see OECD, Action 6: 2015 Final Report, supra note 1, at p.20. At p.21 of the same report the October 2015 version of the rule may be found:
'Article X
Entitlement To Benefits
[1.10 [Provision that would deny treaty benefits to a resident of a Contracting State who is not a "qualified person" as defined in paragraph 2]
2. [Definition of situations where a resident would be a qualified person, which would cover
a) an individual;
b) a Contracting State, its political subdivisions and entities that it wholly owns;
c) certain publicly-listed entities and their affiliates;
d) certain charities and pension funds;
e) other entities that meet certain ownership requirements;
f) certain collective investment vehicles]
3. [Provision that would provide treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income is derived in connection with, or is incidental to, that business]
4. [Provision that would provide treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits]
5. [Provision that would allow the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraphs 1 to 4]
6. [Definitions applicable for the purposes of paragraphs 1 to 5]'
According to the OECD, the alternative "reflects the intention of the Contracting States to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The drafting of this Article will depend on how the Contracting States decide to do so. Depending on their own circumstances, States may wish to adopt only the general anti-abuse rule of paragraph 7 of the Article, may prefer instead to adopt the detailed version of paragraphs 1 to 6 that is described below, which they would supplement by a mechanism that would address specific conduit arrangements, or may prefer to include in their treaty the general anti-abuse rule of paragraph 7 together with any variation of paragraphs 1 to 6 described below", see OECD, Action 6: 2015 Final Report, supra note 1, at pp.21-22.

932 The OECD has indeed tried to confront the issue of tax treaty entitlement in *inappropriate circumstances*, see OECD, Public Discussion Draft, supra note 27.

of an LOB clause raises the question as to the potential impact of the addition on the 'liable to tax' criterion which, at the outset, defines the range of persons authorised to claim treaty benefits. There are several aspects of the proposed rule which, in the sphere of the definition of residence, are worthy of consideration.

11.2.4.2. Scope and nature of the proposed LOB provision

Rather than focusing on the income for the purposes of which treaty protection is invoked, as in the case of the GAAR, the LOB provision focuses on the person claiming such benefits. This person is prevented from using *a benefit*[933] under the Model if it cannot[934] be described as a 'qualified person'.

The manner in which the exclusion from the scope of the treaty is done is quite peculiar, because the rule sets out a general exception to the rule of Art.1 OECD MC[935] by introducing the concept of 'qualified person'. The new rule is not meant to deal with the definition of residence[936] and it operates on the basis of this characterisation[937]. However, there are aspects of the rule which touch upon some sensible elements of Art.4 OECD MC, particularly in relation to lack of any limitations in order to access tax treaties from a domestic angle. These elements are crucial when examining the case of a person who is able to create a tax liability in a wholly artificial manner and therefore to obtain treaty entitlement. After all, the OECD has actually attempted to tackle these situations by interpreting the definition of residence.

As has been stated earlier, from an historical perspective, the issue of conduit and base companies was confronted by promoting an interpretation of Art.4 OECD MC. Despite being residents domestically, these conduit companies were not supposed to be considered as such under tax treaties, because the Model was meant to be available only to 'real' residents and not to those merely created in paper. Under the OECD's traditional argument the term 'resident' was supposed to reflect a certain level of attachment (effective presence), which was relevant for the purposes of the State extending its tax jurisdiction over the person[938]. In reality, however, as has been shown in other parts of this study, this argument is undermined by the Commentaries setting out *no standards* for domestic residents to become residents at the treaty level.

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933 The change from "the benefits" in March 2014 to "a benefit" in September 2014 may be indicative of the more restricted scope of the provision when entering into the issue of tax treaty entitlement.

934 It is interesting to notice that the rule is grammatically drafted in the negative, as in the case of the LOB rule in the US Model, see Avi-Yonah, Reuven, et al, 'The New United States Model Income Tax Convention' in 61 *Bulletin for International Taxation* 6 (2007), at p.231. See in this respect Ellis, Maarten, 'The Judiciary and the OECD Model Tax Convention and its Commentaries – Response to Mr Justice van Brunschot', in 59 *Bulletin for International Taxation* 1 (2005), at p.13.

935 OECD, Action 6: 2014 Deliverable, supra note 902, at p.12. Under the final version of the Commentaries, published in October 2015, "the [LOB rule] restricts the general scope of Article 1, according to which the Convention applies to persons who are residents of a Contracting State", see OECD, Action 6: 2015 Final Report, supra note 1, at p.23.

936 Van Weeghel, Stef, 'Netherlands/United States. The New US-Netherlands Tax Treaty Protocol', in 44 *European Taxation* 9 (2004), at p.391.

937 Gyöngyi Végh, Perla, 'OECD. The 2003 OECD Model', in 43 *European Taxation* 7 (2003), at pp.245-246; "the taxpayer must be a resident under Art.4 of the new treaty *and* satisfy all the requirements for that benefit *and* the LOB article", see Hji Panayi, Christiana, 'European Union. Limitation on Benefits and State Aid', in 44 *European Taxation* 2 (2004), at p.86.

938 Vogel, supra note 6, at pp.232-233. Jung, considering the Model's aim to promoting international trade and investment and the development of markets, explains the necessity of 'a "market-economy connecting factor" between the person who requests relief from source taxes of a contracting state and the other contracting state where the person is resident', see Jung, supra note 14, at p.233.

The LOB rule has been proposed to fill this gap in the Model. The provision seeks to require effective presence in the State in which treaty benefits are claimed:

> "The provisions of the Article seek to deny treaty benefits in the case of structures that typically result in the indirect granting of treaty benefits to persons that are not directly entitled to these benefits whilst recognising that in some cases, persons who are not residents of a Contracting State may establish an entity in that State for legitimate business reasons."[939]

The purpose of the rule is, in other words, to set minimum standards for the treaty claimant in the State in which treaty benefits are claimed. By establishing this parameter one might argue that the rule is indirectly setting up standards for domestic residents to access tax treaties. Thus, one may be led to believe that the LOB clause increases the threshold in terms of the level of connection a person must have with the State in which treaty benefits are claimed[940]. It could be understood that the addition of an LOB rule has a natural effect on the definition of the term 'liable to tax' because, by dealing with the sufficiency of the link[941], the rule would be re-defining the term from a treaty perspective[942]. The answer to this question, however, is not self-evident.

In principle, according to the explanations given by the OECD, it does not seem that the LOB clause is meant to complete the meaning of residence in Art.4 OECD MC, let alone to define the term in a new manner. Yet whether the LOB rule is able to influence the attribution of its ordinary meaning to the term 'liable to tax' by affecting the context in which the term must be defined depends on the provision being able to modify the rules according to which tax liability is determined for the purposes of the treaty. If one needs to explore that question from the perspective of the Model itself or, in the case of this section, of the proposed rules, the nature of the requirements imposed to become a 'qualified person' need to be examined first.

11.2.4.3. The fundamental features of a 'qualified person'

In order to determine whether the LOB clause re-defines 'liable to tax' in the context of the Model, one needs to look at the fundamental features of the provision itself. The expression 'qualified person' refers to those persons in relation to whom, in a situation of potential abuse, it could be assumed that the benefits of the Model were intended, proper or duly obtained. When describing a 'qualified person', however, the LOB rule neither defines nor explains its main features to understand why it is granted access to *intended* treaty benefits. On the contrary, it only illustrates the situation through a list of cases. It is interesting to notice that the list of qualified persons does not vary regardless of whether the States use the *simplified* or the *detailed* version of the LOB rule[943].

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939 See the new Commentaries attached to the limitation-on-benefits provision in OECD, Action 6: 2014 Deliverable, supra note 902, at p.31; OECD, Action 6: 2015 Final Report, supra note 1, at p.23. See comments of the US Delegation 1962 in TFD/FC/136. See Avi-Jonah's comments on 'bona-fide' commercial structures, supra note 749, at p.23; and OECD, Action 6: 2015 Final Report, supra note 1, at p.23.

940 When exploring the compatibility of LOB provisions and EU law, Calejo Guerra has noticed that LOB provisions impose, in general, 'certain "attachment to the jurisdiction" requirements', see Calejo Guerra, supra note 922, at p.85.

941 Valente, Piergiorgio, 'Analysis of certain anti-abuse clauses in the tax treaties concluded by Italy', in 54 *Bulletin for International Taxation* 1 (2000), at p.45.

942 It may be argued that the rule influences the context in which its ordinary meaning needs to be attributed to the term 'liable to tax', according to the rules of the VCLT, see Chapter 9, at pp.129ff.

943 This list is allegedly meant to denote the "nature and attributes" of the categories of persons accepted, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.31, because in fact "it is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 5, discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval", see OECD, Action 6: 2015 Final Report, supra note 1, at p.25.

The rule refers in the first place to individuals, yet nothing is added in relation to them[944]. If an individual is a resident of a contracting State, then that individual is automatically a 'qualified person' for the purposes of the LOB clause. The rule then refers to the State and any political subdivisions or entities the State wholly owns. It explicitly recognises the principle added to Art.4 OECD MC in 1995, according to which the State and its subdivisions are granted tax treaty entitlement despite the fact that they are not actually subject to their own tax jurisdiction[945].

The most extensive part of the provision is related to entities. It refers, in the first place, to publicly traded companies. The treaty claimant needs to be a company traded in the stock market of the alleged State of residence while, at the same time, either having its principal place of management therein or a minimum percentage of shareholders who are residents in that State. These companies deserve treaty access because of the widespread ownership of its stock, which is something that, according to the OECD, makes them unlikely to be established for treaty shopping purposes[946]. It must be borne in mind that the OECD does not exclude the possibility of a publicly traded company having a slight level of economic connection with a given State[947]. In such a case, an entity will still be considered to be a 'qualified person' if it demonstrates that its 'primary place of management and control'[948] is situated therein.

Beyond these cases, the LOB rule grants the status of 'qualified person' to a list of non-profit organisations[949] to be determined by the contracting States during the negotiation process. Moreover, it recognises that status in respect of entities that administer or provide pensions or other similar benefits[950], and finally in relation to entities that invest money derived from pensions[951]. It is relevant to underpin that the reasons for their inclusion within the scope of the Model are not explained in the proposed Commentaries, beyond the valuable social function they pursue[952].

Furthermore, in relation to entities the LOB rule contains an additional ownership and base erosion test[953]. The status of 'qualified person' will also be granted to those persons the property

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944 Not even in the new proposed Commentaries, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.33; OECD, Action 6: 2015 Final Report, supra note 1, at p.25.

945 Sec.8.4 of Comm. to Art.4 OECD Model Convention (2014).

946 OECD, Action 6: 2014 Deliverable, supra note 902, at p.35; OECD, Action 6: 2015 Final Report, supra note 1, at p.26.

947 For instance because its shares are traded in a foreign market, see the Commentaries of the LOB rule in OECD, Action 6: 2014 Deliverable, supra note 902, at p.35.

948 Commentaries proposed on LOB rule, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.35, and the final version in OECD, Action 6: 2015 Final Report, supra note 1, at p.49-50. It is interesting to highlight that the primary place of management and control has been considered to be effective enough in order to demonstrate substantial presence, something that may be debatable from the perspective of the place of effective management test, which has many inherent difficulties, see van der Weijden, Maarten, 'The New Protocol to the Netherlands–United States Tax Treaty', in 58 *Bulletin for International Taxation* 7 (2004), at pp.305-306. The risk associated with this rule may be explained by quoting van Weeghel: "an anti-abuse provision that does not define the abuse it intends to counteract is bound to contain overkill", see van Weeghel, supra note 936, at p.392.

949 In a previous version of the rule (March 2014) an express mention was made to entities carrying out religious, charitable, scientific, artistic, cultural, or educational purposes. In a newer version of the rule (September 2014) the list was left open, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.38. The final version of the rule mentions only charities and pension funds, leaving the list open in the broad version of the rule in the Commentaries, see OECD, Action 6: 2015 Final Report, supra note 1, at p.21, and at pp.28-29.

950 Provided that at least 50 per cent of the beneficial interests in it are owned by individuals who are residents in that State, see OECD, Action 6: 2015 Final Report, supra note 1, at p.29.

951 Provided that substantially all the income of that person is derived from investments made for the benefit of these persons, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.25.

952 OECD, Action 6: 2014 Deliverable, supra note 902, at p.38; OECD, Action 6: 2015 Final Report, supra note 1, at p.29.

953 OECD, Action 6: 2014 Deliverable, supra note 902, at p.39; OECD, Action 6: 2015 Final Report, supra note 1, at p.30.

or voting power of which is controlled in a least fifty per cent by residents of the State in which treaty benefits are claimed[954], provided than less than half of its gross income is paid or accrued to residents of other States in the form of deductible payments[955]. Lastly, the rule deals with the situation of certain entities which may not be 'qualified persons' but that are nonetheless residents engaged in business activities carried out in the other contracting State. In such a case, those residents will have the right to use the benefits of the relevant treaty for any income that is derived from, or incidental to, its activities in the other State.

To sum up, the LOB rule contains a mixture of tests in order to restrict the use of the Model only to certain residents who meet some objective criteria. While in principle the tests contained in the LOB provision refer to the level of connection between the person and the respective State, defining that connection through arguments of property, management or control, it is not clear whether this new rule re-defines tax liability on the basis of an effective economic attachment[956].

11.2.4.4. Redefining 'liable to tax' through an LOB clause

11.2.4.4.1. LOB: A matter of effective economic allegiance?

Profit shifting is an issue of economic connections. The BEPS project was born to oppose the use of treaties in the absence of an effective economic nexus between the claimant and the State in which treaty benefits are requested. In other words, one could understand that the initiative is intended to provide the Model with something it lacks: relevant substance for judging the appropriateness of a tax treaty claim. The ordinary meaning of the term 'liable to tax' in Art.4 OECD MC, on the contrary, is purely formal. It refers to a certain attachment between a person and a State capable of triggering the extension of that State's tax authority over the person. The OECD did not originally intend to restrict in any manner the determination of residence at the domestic level for the purposes of the Model, despite the later additions to the Commentaries to that effect. Whether the LOB rule aims to modifying that by setting up a standard of effective economic allegiance is quite a different but fundamental question.

11.2.4.4.2. Individuals as qualified persons and their tax liability

The LOB rule acknowledges the attribution of the character of 'qualified person' to individuals as such, without any further requirements. When analysing what it is that makes an individual worthy of the characterisation as a 'qualified person' merely because of his existence, one cannot but conclude that the reason for this lies in the individual's physical presence in a certain State[957]. Compared to the situation of companies, the existence and location of which can be manipulated at will, given the individual's physical existence their *presence* is less likely to be faked.

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[954] Despite the reference to 'shares' the rule is applicable also to publicly traded trusts, see OECD, Action 6: 2015 Final Report, supra note 1, at p.26.

[955] Except if those payments are made under Arm's Length conditions.

[956] To some, "[t]he assumption underlying these tests is that a taxpayer who meets the requirements of one of these tests has a structure with a valid business purpose and that this purpose outweighs any goal of obtaining treaty benefits", see Rasmussen, Mogens et al, 'Denmark. The "Limitation on Benefits" Provision in the Tax Treaty with the United States', in 41 *European Taxation* 4 (2001), at p.139.

[957] There are no further explanations in the proposed commentaries. Individuals would have the need of establishing "a real social and economic presence in a state in order to become residents", see Duff, supra note 157, at p.77. Maisto has explained that the election of the criteria for individuals 'was based on "fair", and traditionally recognised standards which rely on sound personal attachments of the individual to the state', Maisto, supra note 538, at p.47.

Yet it is one thing for an individual to be present in one State and quite another thing to conclude that, because of that presence, the individual possesses a strong economic nexus with that State[958]. Such an assumption in modern times may actually be misleading. Some States grant residence to individuals on the basis of a stay of a certain length[959], habitual abode[960], nationality[961], or domicile[962], criteria that may not be even remotely connected with the economic dimension of the person. Individuals can in fact be present in a certain State while deriving most of their income from another State[963]. The possibility of segregating income from its sources in order to carry out a strategy of profit shifting is not at all strange to sportsmen, artists, professionals, investors, and many other individuals.

Residence of individuals portrays more a political than an economic connection[964]. It reflects an attribute that is closer to a right attached to personality rather than a quality that is given by the person's effective economic allegiance with a given State. The characterisation of an individual as a resident at the domestic level tends to ignore the economic dimension of the person, somewhat assuming that the place where the individual is present is, at the same time, the place where his main economic activities are carried out.

Bearing in mind that the LOB rule changes nothing in relation to individuals, the question arises as to whether the purpose behind the LOB rule is really to embed some relevant substance in the rules dealing with tax treaty entitlement in general. At a more fundamental level, one may wonder whether the LOB rule is really setting a standard that is different from those the OECD has sought to impose.

The case of individuals illustrates quite accurately the fact that the LOB clause does not aim to modify the meaning of the term 'liable to tax'. Even under the new rules, all an individual requires to obtain treaty protection is to prove that he is a resident domestically. Individuals need not demonstrate the existence of any economic nexus to obtain treaty protection, and they will continue to be able to segregate income from their sources even if the circumstances in which they do so are not coherent with economic reality.

11.2.4.4.3. Non-profit organisations and their tax liability

The LOB clause defines non-profit organisations[965], pension funds and 'funds of funds'[966] as 'qualified persons'[967]. Beyond the valuable purpose these entities serve from a social perspective,

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958 It is interesting to consider the views of Sadiq when analysing "physical presence as opposed to economic activity", see Sadiq, supra note 162, at pp.184-186.

959 The 183-day in Australia, see Dirkis, supra note 238, at p.208; and the stay exceeding six months in Norway, see Hveding, S., and Backer-Grøndahl, F., 'The concept of Residence for Tax Purposes in Norway', in 56 *Bulletin for International Taxation* 8 (2002), at p.428.

960 Austria, see Daurer, supra note 238, at p.248; France, see Message, supra note 238, at pp.338-339, combining permanent home and principal abode; Germany, see Rust, supra note 216, at p.367; habitual residence in Spain, see Nuñez Grañon, supra note 240, at pp. 513-514.

961 Or citizenship, as in the case of the United States.

962 Australia, see Dirkis, regarding individuals, supra note 83, at p.208; Austria, see Daurer, supra note 238, at p.248; Belgium, see Bellens, supra note 238, at p.281; France, see Message, supra note 238, at p.337; Germany, see Rust, supra note 216, at p.367; United Kingdom, see Lemos, supra note 217, at pp.597-598.

963 See some comments on the Pavarotti case in Rotondaro, Carmine, 'Italy. The Pavarotti Case. Decisions of the Tax Court of First Instance of Modena of 9 February 1999 and the Tax Court of Second Instance of Bologna of 27 March 2000', in 40 *European Taxation* 8 (2000).

964 See supra, at pp.161; Schön, supra note 160, at pp.90-94.

965 Singled out by the contracting States. The Commentaries put the example of charities, educational, religious, which were actually in the original rule of March 2014.

966 Dedicated to invest the money of pensions, OECD, Action 6: 2014 Deliverable, supra note 902, at p.38.

the OECD has not explained why they are eligible for claiming the benefits of the Model. From these limited explanations, it appears that they are granted the status of 'qualified person' only because an exception must be made to the main rules on tax treaty entitlement (just as it occurs with the State and its political subdivisions), and not on the merits of their economic allegiance with a certain State.

There is an aspect of the provision that seems to be crucial in relation to these entities. According to the OECD, the existence of a 'qualified person' requires its foregoing characterisation as a 'resident of a contracting State'. However, the question of whether these non-profit organisations may or may not be granted such a status is a question that does not frequently find a straightforward answer[968]. As a matter of fact, not even the OECD has been able to clarify this point[969].

The LOB clause does not seek to modify the meaning of 'liable to tax' in the case of non-profit organisations. They are mentioned in the rule, just as the State and its subdivision, in order to set out an exception to the general provisions of the Model. However, that exception operates on the basis of the previous characterisation of these entities as 'residents'[970]. Differently from the case of the State and its subdivisions, in which the status of resident is acknowledged in Art.4 OECD MC expressly, non-profit organisations will continue to be subject to scrutiny and their situation will remain uncertain under the application of this new rule.

11.2.4.4.4. Tax liability of entities and the LOB rule

The answer to the question of whether the LOB clause alters the definition of 'liable to tax' in the case of entities is less forthright, because the rule indeed seems to re-qualify the nexus required for an entity to access the Model. There are, however, many things to say in relation to the test for companies before simply concluding that the new rule affects the ordinary meaning of 'liable to tax'.

While it is clear that the new LOB rule raises the threshold for an entity to have access to the Model, to determine whether the LOB rule requires a different kind of tax liability for entities requires a different analysis. Arguably, this question needs to be confronted by discussing whether, from the time of the inclusion of this provision in the Model, these entities need to be 'liable to tax' not only by reason of a connecting factor (domicile, residence, place of management or any other criterion of a similar nature) but, eminently, by reason of their effective economic allegiance with the alleged State of residence[971].

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967 OECD, Action 6: 2014 Deliverable, supra note 902, at p.38. In relation to the LOB rule, the new Commentaries clarify that they "automatically qualify for treaty benefits without regard to the residence of their beneficiaries or members", OECD, Action 6: 2015 Final Report, supra note 1, at p.29.

968 Ward, supra note 13, at pp.418-419; IFA, '53rd IFA congress, 1999. Summaries of discussion on subjects I and II', in 54 *Bulletin for International Taxation* 2 (2000), at pp.87-90.

969 Sec.8.6 and 8.7 of Comm. to Art.4 OECD Model Convention (2014) seem to present a contradiction. The OECD has in fact had to recognise, in the context of BEPS, that "[a]dditional work will also ensure that a pension fund should be considered to be a resident of the State in which it is constituted regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that State", see OECD, Action 6: 2015 Final Report, supra note 1, at p.29.

970 Unless of course one understands that the LOB rule contains an assumption that a person who is a 'qualified person' must also be considered to be a 'resident of a contracting State', which is something that has not been stated in any way in the context of the new rules. In fact, it has long been recommended to include these entities in the text of Art.4 OECD MC as well, see Ward, supra note 13, at p.423.

971 Or by reason of any other factor different from those contained in Art.4 OECD MC and its Commentaries, by way of illustration, as a result of the application of a limitation-on-benefits rule.

Raising this very precise question is therefore the key to understanding the fact that there is no material influence on the attribution of its ordinary meaning to the term 'liable to tax' from the addition of the LOB rule to the OECD MC. As a matter of fact, when analysing the residence requirement, it does not appear that the LOB opposes the consideration of domestic residents as treaty residents. On the contrary, the rule operates on the basis of this characterisation.

The spirit of the rule is only to reduce the scope of persons which are entitled to use the Model by setting up requirements that are in addition to those contained in Art.4 OECD MC, exactly as it occurs with the beneficial ownership test contained in Art.10 and 11 OECD MC[972]. The filters created by the rule to exclude conduit companies from tax treaty entitlement do not refer to the level of connection between that company and the relevant State. By referring to factors such as ownership or place of management, and by disregarding their economic activities, the OECD has made a choice. It has chosen to measure the appropriateness of treaty benefits in cases of entities by enumerating and defining the kind of persons which would be accepted to obtain treaty benefits, and not the properties of the link such a person must have with the State in which treaty benefits are claimed.

Even in the presence of an LOB rule, it is clear that 'tax liability' of entities continues to be what it was in the context of Art.4 OECD MC before the addition of the LOB rule. An entity only needs to demonstrate that it is submitted to a State's tax authority to be considered to be 'liable to tax'. While the LOB provision backs up and reinforces the definition of residence in order to take care of those cases in which the definition is too broad, it does so by including an additional test which need to be met, and not by redefining tax liability.

Although the LOB rule has re-defined 'presence' for the purposes of tax treaty entitlement in the case of treaty shopping[973], if the question were raised as to whether a conduit company is a resident, that question should not be affected by the new LOB provision. On the contrary, it should be addressed by reference to the rule of Art.4 OECD MC alone, that is, according to the laws of the State of residence, with all the problems described in other parts of this study. The LOB provision is meant to restrict the scope of Art.1 OECD MC in terms of setting up boundaries for the definition of the term 'person' but not to the term 'resident', by not redefining the attachment an entity must have with a certain State in order to successfully claim the benefits of the OECD MC.

11.2.4.5. Evaluation: The LOB rule and the definition of residence

There are several questions generated by the conduit issue and one needs to be very careful when facing these questions from the perspective of Art.4 OECD MC. The first question is whether the LOB sets out new standards for accessing tax treaties, and the answer to this question is clearly affirmative. The rule reinforces the definition of residence through a series of tests involving ownership, management and control, amongst other tests. However, the rule reinforces the function of residence in terms of judging the appropriateness of a treaty claim without re-qualifying the conditions the Model imposes for a person to be 'liable to tax'. In other words, this

[972] Oliver, David, et al., 'Beneficial Ownership', in 54 *Bulletin for International Taxation* 7 (2000), at p.318.

[973] The OECD has recognised that the LOB rule is restricted to counter treaty shopping, and does not address other forms of abuse, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.23; OECD, Action 6: 2015 Final Report, supra note 1, at p.19.

new version of the OECD MC requires the presence of 'qualified persons', and not of 'qualified residents'[974].

Whether a conduit structure will be excluded from the application of the Model under the LOB rule is not a question that will be addressed by analysing the tax liability of such an entity but, on the contrary, somewhat assuming that the company has in fact passed that test. In other words, the LOB provision only becomes useful if the residence test has been overcome. Under the new version of the Model, the authority of a conduit entity to claim treaty benefits is not to be challenged from the standpoint of Art.4 OECD MC alone, but from the perspective of the additional alternative test[975] contained in the LOB rule.

In conclusion, it is clear that the LOB provision takes care of the definition of residence being too broad and this is a most welcome upgrade to the OECD MC. However, it needs to be borne in mind that, by not touching upon the matter of tax liability in order to do so, the proposed rules leave some of the questions posed by the BEPS initiative unanswered. Tax dodging in the case of individuals, for instance, is one of those questions. Tax savings in cases of entities that, despite being owned in a certain State, posses a slight level of economic activity in that State, is another. More generally speaking, there are questions of *appropriateness* of treaty benefits that, despite the complexity of the new LOB clause[976], will certainly remain unanswered.

Lastly, it is relevant to highlight that there are many questions related to the appropriateness of the tests contained in the LOB rule in order to measure an entity's level of attachment with a certain State that will also remain unanswered. Whether the rule rightly judges the level of relevant substance behind an entity's operations in order to deal with the issue of tax treaty entitlement is a question that greatly exceeds the boundaries of this study. Yet, it is somewhat evident that the discussion as to whether this rule crystallises the objectives sought by the BEPS initiative in the field of tax treaties is not necessarily exhausted[977].

11.3. Evaluation: Residence and the need for an economic nexus from the perspective of a new version of the OECD MC

When the issue of treaty abuse was raised in 1962 it was fairly obvious that the discussion was aimed at positioning the issue of tax treaty entitlement as an international concern. The definition of *relevant substance* was something unfamiliar to most States, and so it was the treaty as an international agreement that was meant to set boundaries in that regard. Nothing concrete has been done from the perspective of the treaty definition of residence in this respect. In 1992 the OECD suggested that the situation of conduits was *per se* abusive without explaining the reasons

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[974] When analysing the LOB provision in the new Belgium-US tax treaty, Bax refers to 'qualified residents' instead of 'qualified persons', see Bax, Arthur, et al., 'The New Belgium-US Income Tax Treaty. An Analysis', in 47 *European Taxation* 7 (2007), at p.352.

[975] Gouthière, Bruno, 'France. Significant Amendments to the France-United States Tax Treaty', in 50 *European Taxation* 5 (2010), at p.181.

[976] It is interesting to examine the reasons given by some authors not to use provisions such as an LOB rule, see for instance the case of Austria in Loukota, supra note 745, at pp.364-371.

[977] Considering, for instance, the fact that the LOB provision requires physical presence in order to obtain treaty benefits, in times in which e-commerce and technological activities do not require such presence at all in order to generate income in a given State, see Freitas de Moraes e Castro, Leonardo, 'US Policy to Counter Treaty Shopping – From *Aiken Industries* to the Anti-Conduit Regulations: A Critical View of the Current Double-Step Approach from the Perspective of Treaty Objectives and Purposes', in 66 *Bulletin for International Taxation* 6 (2012), at p.303.

for such a statement[978]. As a matter of fact, the OECD persisted in stating that the Model was not supposed to create standards for domestic residence in order to generate treaty residence.

The 2015 proposal of general anti-abuse and limitation-on-benefits provisions to be added to the Model seems to have changed the paradigm over which tax treaty entitlement needs to be analysed. These new rules set boundaries for a definition of *intended* or *proper* tax treaty entitlement, and they greatly clarify some cases in which treaty access is duly obtained. It is clear that the decision of whether a person is eligible for claiming the benefits of the Model under its updated version will be approached differently than the process of making the same judgement under its unmodified version. In a way, this implies that the appropriateness of treaty benefits will have to be considered on the basis of two different *versions* of the OECD MC.

Despite forming part of a new version of the Model these new rules do not change the manner in which Art.4 OECD MC needs to be examined. Under the new GAAR and LOB provision tax liability is, and continues to be, essentially a domestic concern, which is at the same time detached from any consideration of the economic activities carried on by the relevant taxpayer[979]. The need for a stronger nexus does not derive from a novel conceptualisation of the term 'liable to tax', but only from the additional barriers these rules impose for the purpose of accessing *its benefits*. It is one thing to say that the GAAR and the LOB provision raise the threshold for taxpayers to be granted access to the Model, and quite another thing to sustain that these rules impose the need for a qualified nexus from the particular perspective of the definition of residence in the Model.

This new version of the Model does not change the formalistic essence of the residence requirement. Individuals, for instance, will continue to be judged solely on the basis of Art.4 OECD MC. The LOB rule, as the OECD has expressly recognised, has the very limited purpose of dealing with certain treaty shopping scenarios. The rule does not seek to include a generic requirement of relevant substance in judging the appropriateness of a tax treaty claim, and this is particularly evident when one observes the effect of the rule on the definition of residence in the OECD MC. The LOB provision not only refrains from getting involved in the characterisation of a person as a resident of a contracting State but it operates, in fact, on the basis of that characterisation.

The general anti-abuse rule, on the other hand, focuses on the items of income for which treaty benefits are requested. The purpose of the rule is not to modify the definition of residence in any manner and thus the ordinary meaning of the term 'liable to tax' is not affected by its introduction. This occurs despite the fact that the artificial character of the arrangements or transactions executed with the view of establishing residence can serve as a basis for the denial of treaty benefits. The treaty claimant preserves his status as a (treaty) resident of a contracting State if the domestic laws of the State in which treaty benefits are claimed grant him that status.

The above-mentioned conclusions are relevant if one considers some of the issues at the core of Art.4 OECD MC, largely described across the length of this study. Similarity in nature, for instance, when looking for criteria equivalent to residence, is one of those aspects that will not vary. One will not be able to reject *incorporation* as a criterion of similar nature because of these new additions. The same may be said of effective taxation as a requirement for tax treaty benefits. By

978 At least from a relevant substance perspective. It has been stated that the OECD tried to explain abuse through the absence of 'full tax liability', which is inconsistent with the framework of the Model and the principles embedded into it, see supra at pp.159ff.

979 Sadiq, supra note 162, at p.173. Bammens and de Broe wonder "how much business must be done in order to pass the economic-substance test", see supra note 292, at p.59. In reality, although the LOB rule imposes the need of presence, it does not necessarily create the necessity of businesses being actually carried out in the relevant State.

way of illustration, the inclusion of non-profit organisations as 'qualified persons' under the new LOB provision does not guarantee that the discussion in relation to their tax liability will be over. On the contrary, the new rule seems to be built upon that foregoing characterisation, for a person needs to be a resident in order to be subject to the test imposed by the LOB rule. One must also bear in mind that these new rules do not impose effective taxation as a standard to access the Model. Under this new version of the OECD MC, it does not really matter if a conduit company is tax-exempt on all its foreign income, as that would not be the ultimate reason to exclude it from the scope of the Model. The lack of relevant substance, which was actually the historical cause of the problem raised in 1962, is effectively going to be solved by these new rules.

All these observations are also relevant if one considers the need to interpret tax treaties in good faith and the debate in relation to the object and purpose behind the Model, because the OECD has sought to clarify, in the context of the BEPS initiative, what the purpose behind the Model was[980]. Yet, whether the purpose of the OECD MC is to allocate tax jurisdiction or if it is restricted to the avoidance of double taxation is an extremely controversial aspect that will persist, and thus some of the obstacles for the determination of the existence of abuse will also remain[981]. Despite the powerful signals sent by the OECD (such as the changes proposed to the title of the Model[982]), everything seems to indicate that the application of tax treaties in scenarios of non-taxation will only be restricted in cases of *evasion and avoidance*[983], and therefore States applying the capital-import neutrality principle will still find enough reason to use the OECD MC in their negotiations.

Furthermore, one cannot miss the fact that the efficacy of the anti-abuse rule is in fact subject to the determination of the object and purpose of the relevant provisions of a treaty, and therefore the role of these new rules in countering abuse may be thwarted as well. The question posed by the BEPS initiative was not only a legal question but also a question to be answered from the perspective of policy considerations. From that specific point of view, one may say that, after the additions, there are more reasons to sustain that a wholly artificial arrangement *should not* be allowed access to the Model[984], and that treaty access in cases of artificial arrangements is inappropriate, from a policy point of view. Yet all this is subject to the condition of the abuse being demonstrated, which is something that is not easy in certain scenarios of treaty shopping[985]

The combined effect of the application of a GAAR and a LOB provision results in the reinforcement of the definition of residence in its role as a filter for proper tax treaty entitlement[986]. In other words, the negative function the definition of residence is supposed to perform, that is, the

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980 OECD, Public Discussion Draft, supra note 27, at pp.27-28; OECD, Action 6: 2014 Deliverable, supra note 902, at p.99; OECD, Action 6: 2015 Final Report, supra note 1, at pp.91-92. See Maisto, supra note 611, at p.335.

981 Bammens, supra note 292, at p.55.

982 OECD, Public Discussion Draft, supra note 27, at p.27; OECD, Action 6: 2014 Deliverable, supra note 902, at p.98; and OECD, Action 6: 2015 Final Report, supra note 1, at p.91.

983 Despite being "undesirable on neutrality and fairness grounds", see Sasseville, supra note 687, at p.246; it appears that the occurrence of double non-taxation will not suffice to argue an abuse of the Model, see Arnold's comments on Justice Miller's findings on the *Antle* case, according to whom the use of an exemption by a trust was not to be stopped through the GAAR, because the exemption was in accordance with the policy objective behind the relevant treaty provision, see Arnold, Brian, 'Tax Treaty News', in 63 *Bulletin for International Taxation* 12 (2009), at p.563.

984 Despite the difficulties in defining what a "wholly artificial arrangement" is, see Zonorza, supra note 775, at p.158.

985 "Treaty shopping is merely a form of tax planning: if it is not abusive, it should be perfectly acceptable", concludes Kandev when explaining, on the basis of some Canadian rulings, the position held by the judiciary in Canada, particularly in relation to its anti-abuse rules, see Kandev, supra note 924, at p.470. According to de Broe, on the other hand, treaty shopping strategies only seek to access treaty benefits, and thus they do not help developing international trade and investment. Because of this, they should be excluded from the application of the Model, see de Broe, supra note 496, at p.374.

986 Wheeler, supra note 11, at p.101.

exclusion of certain tax treaty claims the merits of which seem questionable, will actually occur. This, however, will not happen because of the elements contained in Art.4 OECD MC, but under the reign of different provisions, and according to standards that are external and unrelated to the definition of residence. The question of whether there is a need to include some substance requirements to the definition of residence[987] will remain unanswered and, in good faith, one will continue to be able to reach the conclusion that a conduit company is a resident for the purposes of the Model. The debate in relation to residence and therefore the cornerstone over which treaty entitlement is analysed will continue to be subject to the same difficulties it was subject to before the BEPS initiative, and before the latest additions to the Model.

[987] Vann, supra note 41, at pp.263-270.

PART IV

MULTIPLE RESIDENCE AND THE TIE-BREAKER

12. Chapter 12
Dual residence conflicts in the OECD MC

12.1. Introduction: Multiple tax liability in the application of treaties

Residence in tax treaties is based on the provisions of domestic law, and this implies the acceptance of the fact that a person may be a resident of multiple States for tax treaty purposes. The OECD MC takes care of this issue by laying down some rules according to which this *tie* between States is broken, and these rules operate on the basis of the distinction between entities and individuals.

This section examines the issue of multiple residence in the OECD MC. By considering the conclusions arrived at in other parts of this study, dual residence is explored in general, from the standpoint of the Model and its history, to set out the interpretation of Art.4(2) and (3) of the OECD MC. This part also delves into the rules for individuals in order to examine each of the tests that are meant to break the tie in such a case. Further, it also includes an examination of the tie-breaker for entities and the manner in which the changes to the Model proposed in 2015 modify the determination of their residence.

12.2. Dual residence in Art.4 OECD MC

12.2.1. Dual residence 'by reason of the provisions of paragraph 1'

As has been stated before, the dual residence conflict arises because the OECD MC defines treaty residence through domestic residence, and because the application of the Model forces one to get to a situation in which there is only one State which has the primary right to tax. The tie, if it exists, needs to be broken for the Model to be applied:

> "The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Conventions to determine which of the two concepts of residence is to be given preference."[988]

The existence of a tie is given by the presence of a person who qualifies as a resident in both States "by reason of the provisions of paragraph 1". This suggests that there is an actual definition of residence in Art.4(1) OECD MC, by reason of which a person needs to be a resident in both contracting States, as has been stated repeatedly across this study. The rule of Art.4(1) OECD MC describes a generic submission to a State's tax authority, which is based on subjective attributes and regardless of the income a person derives. This is the definition of residence to which Art.4(2) and (3) make reference when instructing the interpreter to break the residence tie.

The problem is also relevant if one considers that a person may shift its residence within the same taxable period[989]. This question was explored extensively in the *Smallwood* case[990]. After residing during part of the year in one State, a person moved its residence to a different State for the rest of

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988 Sec.5 of Comm. to Art.4 OECD Model Convention (2014).
989 See *moment of tax liability* in Chapter 6, supra at pp.66ff.
990 See *Smallwood*, supra note 307.

the year. Under their domestic laws, both States claimed the right to tax the person as a resident for the entire period. Accordingly, having received income during the period of residence in the first State, both States nonetheless claimed the right to tax that income as the State of residence[991]. Despite the fact that the person was not a dual resident at the exact time of receiving the income, both States justified their tax claims because the person was considered to be 'liable to tax' by them, even if at different times, for the entire taxable period. Although the taxpayer argued the need to look at the situation at the precise moment the income was received, using a snapshot approach[992], the court disregarded the argument, and treated the taxpayer as a dual resident[993].

The Commentaries propose the opposite interpretation of the rule of Art.4 OECD MC. Arguably, this interpretation seeks to create a standard for domestic residents, according to which the treaty claimant needs to be treated as a treaty resident in each State only for the relevant section of the taxable period[994]. Yet the fact that residence is conceived as a domestic and a subjective[995] attribute in the Model supports the reasoning of the courts, and so does the idea that the Model seeks to impose no standards for domestic residents to access the Model. That being the case, it is relatively clear that the dual residence conflict arises even in the absence of simultaneous residence in two States[996]. The domestic character of tax liability, one may easily conclude, increases the potential for dual residence conflicts to arise. While arguments may be presented against the convenience of this reasoning, it is the spirit of the Model, after all, which gives preference to what the laws of the States define as relevant domestically in the context of tax liability at any given time.

12.2.2. A definition of residence and the tests in the tie-breaker[997]

The question of whether there is a definition of residence in Art.4(2) and (3) OECD MC and the question of whether the terminology used in these provisions needs to be defined at the international or at the domestic level are two questions which, despite representing different concerns, are intertwined in a series of aspects. It may be relevant to highlight that, historically, the purpose behind the creation of the tie-breaker was to introduce a treaty definition of residence, capable of superseding the domestic ones, precisely to give preference to one over the other:

> "[the dual residence issue] must, and only can, be solved by agreement on the application of a preference criterion laying down which of the two countries is to take priority with respect to their claims for tax based on their internal legislation concerning domicile and *thereby limiting the national concepts of domicile of the two countries*."[998]

The quest for a definition of residence arose precisely, and only because of, the dual residence conflict. As has been explained in other parts of this study, Art.4 OECD MC was conceived as a

991 In the Special Commissioners' opinion in the Smallwood case: "we do not consider that "by reason of…residence" means solely past or current residing. If residing in a subsequent period causes residence for the whole year, then liability is by reason of residence", *Smallwood*, supra note 18, at para.102.
992 What was called by the defendant a 'snapshot approach', see *Smallwood*, supra note 307, at para.65.
993 Lemos, supra note 217, at pp.620-621.
994 Sec.10 of Comm. to Art.4 OECD Model Convention (2014).
995 This would have been avoided if tax liability was analysed on the basis of the income instead of the person, see Wheeler's analysis of the Smallwood case in Wheeler, supra note 11, at pp.125-131.
996 Although Sasseville does not agree, Sasseville, supra note 314, at p.51.
997 For a complete historical background see Chapter 2, at pp.16ff.
998 Emphasis added. FC/WP2(56)1, at p.2.

solution for this problem only, and not as a generic definition of residence[999]. Yet, while the purpose of the tie-breaker was to define residence at the treaty level, whether the so-called *limitations* to the internal concept of residence in Art.4(2) and (3) OECD MC are capable of setting out a distinct definition of residence, that is a sensibly different question.

The tie-breaker rule is in principle only meant to set out objective criteria capable of solving a very concrete problem: the need to choose between two nexus with two different States. This is done through a series of elements such as permanent home, centre of vital interest, habitual abode, place of effective management, amongst others, which are allegedly meant to clarify which of the two attachments is *stronger*[1000]. One may argue that if a person is liable to tax in two States, his tax liability will be stronger if it is based on having, for instance, a permanent home in one State, rather than simply having his centre of vital interests or his habitual abode therein.

Although this is the logic behind the Model, it is hard to see how it is that the criteria contained in the rule affects the *quality* of the nexus required for a claim to prevail. In other words, it does not seem that the tie-breaker is meant to re-define the kind of attachment a person must have to be considered as a resident under Art.4(1) OECD MC. It appears that the purpose of the rule is, more precisely, to manifest the need to ignore the rules of domestic law and to break the tie on the basis of international standards, providing enough certainty to the application of the Model.

Therefore, while there is no concrete definition of residence if one looks at the tie-breaker itself, the treaty definition of residence would arise whenever the factors that the OECD has considered to break ties are attributed their meaning at the treaty level and not at the domestic level. This idea is relevant if one considers the lack of clarity as to the source from where the terms contained in the tie-breaker need to be defined. There is no clarity as to whether expressions such as 'permanent home' need to be defined at the treaty level or, following the general rules laid down in Art.3(2) OECD MC, under domestic law, unless the context otherwise requires[1001].

As early as in 1981 Avery Jones justified the need to provide the terms in Art.4(2) and (3) OECD MC an international fiscal meaning, by explaining that the context obliges the interpreter to dismiss the domestic meaning of those expressions[1002]. In addition to the arguments presented by Avery Jones, it is clear that the rule of Art.4(2) and (3) OECD MC would be, more than properly re-qualifying the attachment which gives place to residence, imposing the need to look at the

[999] See Chapter 2, at pp.16ff. Cases of single residence were to be analysed solely on the basis of the provisions of domestic law: "The draft Article is intended *only* to solve the conflict between two domiciles" (emphasis added). Similar to the current version of the Commentaries, the old version declared the relevance of the concept of residence in three cases: a) in determining the scope of application of the convention; b) in solving dual residence conflicts and c) in solving conflicts between residence and source. The draft rule, under its original formulation, was expressly meant to deal only with the second objective, see FC(58)2(1st Revision) Part II, at p.16. This changed afterwards, when the OEEC modified the Commentaries to state that: "The Article is intended to define the meaning of the term "resident of a Contracting State" *and to solve cases of double residence*", see Sec.2 of Comm. to Art.4 OECD Model Convention (2014). In all other cases, as Vogel has explained, "if there is only one residence under the domestic law of one contracting State, then that residence is also the relevant treaty residence", see Vogel, supra note 6, n.99, at p.261.

[1000] FC/WP2(57)1, at p.5.

[1001] Art.3(2) OECD Model Convention (2014).

[1002] These reasons are: firstly, that at least one of these expressions is unlikely to have an internal fiscal meaning under one of the State's laws; secondly, that the expressions used in the OECD MC are presumably intended to be given the same meaning by the States using the Model; thirdly, that the States may have more than one definition for any of these terms under domestic law, and fourthly, that the Commentaries indicate that the expression must be given an international fiscal meaning, see Avery Jones et al., 'Dual Residence of Individuals: The Meaning of the Expressions in the OECD Model Convention – I', in 1 *British Tax Review* (1981), at pp.20-22.

problem of residence from an international point of view, and therefore setting out an exception to Art.3(2) OECD MC[1003].

In a way, if one defines these terms on the basis of domestic law, there would be no *treaty* definition of residence in Art.4(2) and (3) OECD MC, but only a second and even more complex redirection to factors which, from a domestic perspective, may be relevant to define residence as an attachment between a person and a State[1004]. On the contrary, the policy objective behind the tie-breaker is to set out rules according to which, regardless of the provisions of domestic law, one may be able to break a tie between States as indisputably as possible[1005]. In that sense, the need for the terms contained in Art.4(2) and (3) OECD MC to be defined not at the domestic level, but at the treaty level, is evident[1006].

The question of whether the tie-breaker contains a definition of residence is relevant from a policy point of view, because it allows the interpreter to conclude that the expressions contained in the tie-breaker demand the adoption of international standards to break the residence tie[1007]. Only in that manner can it be properly said that the rules of the tie-breaker, and thus the OECD MC, contain a definition of residence which is different from the domestic one under the provisions of paragraph 1 of Art.4 OECD MC[1008].

12.2.3. Solution for dual residence: The preference criterion

The OECD historically chose the path of breaking a tie between States by giving *preference* to one claim over the other:

> "At a clash of the internal concepts of domicile of several states there is a conflict of interests which, in the events here discussed, must, and only can, be solved by agreement on the application of a preference criterion laying down which of the two countries is to take priority with respect to their claims for tax […]"[1009]

The current Commentaries to Art.4 OECD MC in fact add:

> "As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State."[1010]

1003 Makovníková mentions that Art.3(2) OECD MC was added to the Model only in 1963, while terms such as 'permanent home' had been used in the Model since the time of the League of Nations, in 1925, see Makovníková, Silvia, 'Permanent home as a tie-breaker criterion', in Hofstätter, Matthias, Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at p.21.

1004 "It would be senseless to rely on domestic law to resolve a conflict that arises by virtue of the application of domestic law", see Pittman, Shauna, 'The Centre of Vital Interests Rule: Do Personal Interests Prevail over Economic Interests?', in Hofstätter, Matthias, Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at p.37.

1005 Sec.10 of Comm. to Art.4 OECD Model Convention (2014). If one considers that these terms, being undefined at the treaty level, need to be defined according to the rules of domestic law, the possibilities of breaking the tie and thus the efficacy of the rules would be reduced significantly.

1006 According to the Four Economists, "domicile or habitual residence must everywhere be interpreted alike for the purposes of taxation […] so that there will be no possibility of misinterpretation", see LON, E.F.S.73.F.19, at p.25[4029].

1007 Vogel, supra note 6, n.67, at p.246. Some authors in fact regret that there has not been an express exception to Art.3(2) OECD MC in Art.4 OECD MC, but they arrive to the same conclusion: Of all the elements in Art.4(2) and (3) OECD MC, nationality is the only one which, on a reasonable and purposeful interpretation of the Model, needs to be defined under internal legislation, see Avery Jones et al., supra note 1002, at pp.15-22.

1008 The purpose of the tie-breaker is to supplement the definition of residence at the domestic level, see Vogel, supra note 6, n.68, at p.246.

1009 Underlined text in original, see FC/WP2(56)1, at p.2.

While it is clear that the object of these rules is to give preference to one claim over the other, it is interesting to note that this is not the only solution the States have implemented to solve the dual residence conflict. In order to prevent the use of the Model for tax avoidance purposes, some States have replaced the preference criterion for a general rule denying treaty benefits in cases of dual residence[1011]. While this eliminates the root of the problem, namely the potential tax avoidance goal behind a residence tie, there are nonetheless *bona fide* situations of dual residence, that occur in the absence of any tax avoidance considerations[1012]. These cases are, however, left without the scope of the Model under the OECD's approach.

12.2.4. The effects of the tie-breaker on domestic law and other treaties: Residence as defined 'for the purposes of *this* Convention'[1013]

The OECD has stated that the purpose of the tie-breaker is to define residence in a way in which one tax claim is given preference over the other. The rule, however, has been attributed other significant effects. In 2008[1014] the OECD promoted an interpretation of the tie-breaker according to which its application affects the status of resident for the purposes of other treaties:

> "According to its wording and spirit the second sentence [of Art.4(1) OECD MC] also excludes from the definition of a resident of a Contracting State [...] companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, while being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States."[1015]

The issue is in fact problematic because there is no agreement in relation to the possibility of supporting this argument from the perspective of the Model itself. The Ministry of Finance and the Supreme Court of the Netherlands have employed this reasoning to deny treaty benefits in a variety of cases[1016], and prominent authors have supported this idea. Sasseville, for instance, has

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1010 Sec.10 of Comm. to Art.4 OECD Model Convention (2014). The origin of these Commentaries goes back to 1957, see FC/WP2(57)3, at p.7.

1011 The denial of treaty benefits occurs directly in the presence of a dual residence situation, as in the case of Art.4(3) of the Australia – Chile tax treaty; or after the mutual agreement procedure has failed to break the tie, see for instance Art.4(3) of the Spain – Chile tax treaty, Art.4(3) of the Switzerland – Chile tax treaty, Art.4(3) of the Belgium – Chile tax treaty. As a matter of fact, the OECD seems to have moved in that direction when introducing changes to the tie-breaker for entities, as will be examined in a subsequent section. Under the updated version of the tie-breaker for entities, proposed in 2015, in the absence of agreement between the competent authorities of each State, the tie is not broken, and treaty benefits are not granted to the dual resident entity, see OECD, Public Discussion Draft, supra note 510, at p.5.

1012 It must be borne in mind "that dual residence is a result of conflicting residency rules of two legislations and is not necessarily related to tax avoidance", see Gyöngyi Végh, supra note 447, at p.162.

1013 This aspect of the definition, from an historical perspective, as been also touched upon in Chapter 2, at pp.20ff.

1014 OECD, *The 2008 Update to the OECD Model Tax Convention*, (Paris: loose-leaf, 2008), at p.6.

1015 Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014). Under the updated Commentaries, '[t]he term "resident", as used in paragraph 3 and throughout the Convention, is defined in Article 4. Where, under paragraph 1 of Article 4, a person is considered to be a resident of both Contracting States based on the domestic laws of these States, paragraphs 2 and 3 of that Article determine a single State of residence for the purposes of the Convention. Thus, paragraph 3 does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State", see OECD, Action 6: 2015 Final Report, supra note 1, at p.88.

1016 The issue was put forward by The Netherlands Ministry of Finance, and the Hoge Raad of the Netherlands upheld the OECD's reasoning in its ruling of 28 February 2001, No.35.557, BNB 2001/295. This has been commented by van Raad, supra note 57, at pp.27-29; Vogel, Klaus, 'Tax Treaty News', in 56 *Bulletin for International Taxation* 1 (2002), at p.2; Betten, supra note 57; Smit, supra note 57, at pp.155-158; Damen, supra note 120, at pp.290-292. It is interesting to highlight that in 1999, at an IFA Seminar in London, there was agreement on the fact that this interpretation was "generally thought to be wrong", see Avery Jones et al., supra note 417, at p.19.

stated that '[u]nlike the first sentence [of Art.4(1) OECD MC], the second sentence does not provide that the relevant liability to tax is that which arises "under the laws of that State." […] The wording of the last sentence read in the context of the treaty and in accordance with the overall purpose of the treaty, would therefore appear to allow a country to take account of the effect of the provisions of its other treaties in determining whether an individual is liable to tax only on income from domestic sources.'[1017]

Van Raad, on the other hand, has sustained the contrary argument[1018]. In his opinion, the expression 'for the purposes of *this* Convention' in Art.4 OECD MC restricts the influence of the Model on the laws of the States and other tax treaties[1019]. A person who loses the tie by this reasoning would not cease to be considered as a resident of that State, because the term resident operates 'for the purposes of this Convention' *only*[1020]. In support of this approach, it is reasonable to observe that a State that gives up its authority to tax certain items of income obtained by specific taxpayers due to a treaty, does not necessarily renounce to treat such taxpayers as residents in relation to other flows of income, or during other taxable periods[1021].

Despite the fact that the OECD has promoted this new interpretation of the Model quite recently, this does not imply that the issue became relevant only in 2008. Whether the rule is apt to generate such a transcendent effect has been debated for decades. As early as in 1964, the Delegation for Japan raised this issue by sending some questions to the Fiscal Committee:

> '2. Suppose the case where a person who is a resident of both of the Contracting States A and B under respective domestic laws (hereinafter called "taxpayer") is deemed as a resident of State B for the purposes of the Tax Convention between State A and State B. How shall State A solve the following problems that may arise in the application of its domestic tax laws? Namely: […]
>
> (2) Whether State A should treat "taxpayer" as a resident of State A for the purpose of its own taxation on condition that it grants him all the benefits for a resident of State B stipulated in the Convention, or State A should treat "taxpayer" wholly as a non-resident. If "taxpayer" should be treated as a non-resident, "taxpayer" might suffer from a disadvantage in a certain case because of the non-applicability of personal deductions or the application of flat tax rate. Should this disadvantage be considered as an inevitable consequence of the application of Article 4? Or is it necessary for State A to give him option to remain a resident of State A for the taxation purposes?'[1022]

The Delegation for Sweden upheld these concerns in 1967:

> "In paragraph 2 of Article 4 rules are given with the intention to solve cases of double residence of individuals. However, quite a few cases have occurred where a taxpayer, who according to Swedish law is clearly resident in Sweden, is considered, for the purposes of a tax convention with another contracting State, as a resident in that State. In these cases the result sometimes has turned out to be unsatisfactory from the Swedish point of view, especially with respect to recent legislative measures introduced in order to counteract tax evasion by means of a transfer of residence."[1023]

[1017] Sasseville, supra note 58, at pp.44.

[1018] Svobodová provides several consistent arguments to support van Raad's position, see Svobodová Jana, 'Treaty entitlement of dual residents', in Hofstätter, Matthias; Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at pp.111-113.

[1019] See van Raad, supra note 32, at p.242; van Raad, supra note 57, at p.29; van Raad, supra note 55, at pp.187-190. The history of the phrase 'for the purposes of this Convention' is explained in detail in Chapter 2, at pp.20ff.

[1020] Vogel, supra note 6, n.98, at p.260-261.

[1021] Svobodová, supra note 1018, at p.113.

[1022] TFD/FC/173, at p.2.

[1023] TFD/FC/216, at p.27. The observation was attached to Art.23 on the methods of relief, because Sweden had dealt with this issue by introducing a special rule in its tax treaty with Switzerland reserving "the right to tax an individual who according to Swedish legislation is resident in Sweden but who according to the Convention is resident in the other contracting State". Switzerland, its treaty partner, introduced an observation to Art.27 on diplomatic

Having considered the issue, in 1975 the OECD observed:

> '5. Each of two Contracting States may subject, under its internal law, the same person to unlimited tax liability, either as a resident of such State, or exceptionally as a national thereof. The Draft Convention aims at avoiding the situation that such person continues to be subjected in both States to tax in his total worldwide income and capital: Under Article 4 of the Convention the person will be considered, for the application of the Convention as a resident of State A only. The intention is that the other Contracting State B should be precluded from taxing income or capital for which the Convention gives the right to tax to the State of residence [...].
>
> 6. One solution would be to state in Article 23 or 23A or 23B quite generally that the income derived or capital owned by a resident of a Contracting State shall be exempt from tax in the other Contracting State, except where another Article of the Convention expressly provides for taxation of such capital or income in the State which is not the State of residence. *The same goal could be achieved by inserting in paragraph 1 of Article 4 after "For the purposes of this Convention" the words: "and the internal law of the Contracting States".*'[1024]

The OECD's position raises many questions in relation to the link between the 2008 interpretation of the rule and the concerns which gave place to the addition of a second sentence to Art.4(1) OECD MC[1025]. Regardless of these questions, it is more or less clear that such an effect cannot be effortlessly attributed to the tie-breaker as such[1026], which is in line with van Raad's thoughts. On the contrary, an express compromise between the States to apply these rules in such a manner is necessary or, in the absence of that, a provision denying the status of resident as an effect of applying tax treaties at the domestic level.

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privileges, stating the need of such rules in the text of the Model. Notwithstanding the clear opportunity to notice the connection between these two issues, no comments were raised in relation to that, see TFD/FC/216, at p.33.

1024 CFA/WP1(75)5, at pp.2-3.

1025 Chapter 7 contains a detailed analysis of the second sentence of Art.4(1) OECD MC, in the context of which it is explained that the addition of this interpretation in 2008 does not find support in the concerns which gave place to the inclusion of the second sentence in 1976. As a matter of fact, both the issue of residence of diplomats and the concerns expressed by the Japanese and Swedish Delegations were in charge of the same working group, and they were nonetheless never mixed up. The records of those sessions were in fact titled: "Working Party No. 28 of the Fiscal Committee. Second report on articles 1, 4, 14 to 20 and 21, and questions concerning annuities and residence of diplomats", see FC/WP28(68)2, at p.1. The OECD, however, 44 years later, surprisingly decided to promote this interpretation and to attach such a transcendent effect to the tie-breaker; see Chapter 7, at pp.84ff.

1026 It is interesting to observe that by 1999, at an IFA Seminar in London there was agreement on the fact that not even the Commentaries to the Model were able to support this interpretation of Art.4 OECD MC, which was in fact "generally thought to be wrong". Avery Jones and Bobbett summarised the conclusions arrived at by Seminar E at the IFA Congress in London, in relation to triangular treaty problems, and they analysed the position of the Netherlands Ministry of Finance in relation to the tie-breaker in order to reach these conclusions. See Avery Jones et al., supra note 417, at p.19. The problems in connection with the mismatch between the treaty and the domestic definition of residence when solving the dual residence conflict have also been underpinned in the field of BEPS, see OECD, Public Discussion Draft, supra note 510, at pp.5-6. From the words of Dirkis, it is interesting to notice how a country like Australia, despite recognising the merits of this approach, has not been fully convinced of applying it, see Dirkis, in relation to corporate residence, supra note 83, at pp.337-338. Austria is another example where the prevailing opinion is that a tie-breaker loser fulfils the criteria of domestic residence and thus for the purposes of treaties, see Simader, supra note 118, at pp.371-372. The same applies in Belgium, see Bammens, supra note 303, at pp.401-402; Germany, see Englisch, supra note 102, at p.504 and at p.515, and Rust, supra note 216, at pp.390-391; Italy, see Dorigo, Stefano, 'Italy' (Country Reports), in Maisto, G., (ed.), *Residence of Individuals under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2010), at p.427; the Netherlands, at least domestically, see de Boer, supra note 141, at p.595, and Gunn, supra note 245, at p.493; South Africa, until finally its laws were amended in 2003, see Hattingh, supra note 235, at p.751; Spain, see Martinez, supra note 235, at p.791, and Nuñez, supra note 240, at p.532; Switzerland, see Maraia, supra note 223, at p.811; and the United States, see Brauner, supra note 111, at p.883.

Some States have in fact opted for treating tie-breaker losers as non-residents[1027]. However, in those cases the fact that the person is denied the resident status does not result from the provisions of the Model, but as a consequence of the laws of that State. After all, a person needs to be a resident "under the laws" of a State to claim treaty benefits. In the absence of an express agreement, that question is finally to be answered on the basis of those laws.

It is evident that the interpretation promoted by the OECD in 2008 had an anti-avoidance purpose[1028], but the manner in which the idea has been proposed does not seem to converge with the rest of the rules of the Model. A person who loses a tie-breaker, in synthesis, needs to be treated as a non-resident for the purposes of domestic law and other treaties because, as a result of the tie-breaker, that person would not be subject to the 'most comprehensive' tax liability imposed by a State.

The consequences of following this line of reasoning have been largely explained in relation to conduit companies[1029]. In the case of the tie-breaker, it may be relevant to reiterate and emphasise that, unless the laws of a State treat a person as a non-resident after losing a tie-breaker, to speak of 'limited tax liability' is erroneous (insofar as the person will remain subject to that State's tax authority[1030]). Although it is evident that the dual residence conflict may be used to abuse tax treaties, this anti-abuse approach is misleading, because it is limited by the Model's incapacity to modify, on its own merits, the provisions of domestic law dealing with residence[1031].

12.3. Tie-breaker for individuals in Art.4(2) OECD MC

12.3.1. Introduction: Breaking the tie through a hierarchy of tests

The need to break the tie and, more precisely, the election of the appropriate criteria to do so in the case of individuals, has been largely discussed by the OECD. By 1956, Working Party 2 had a broad notion of the tests needed to break ties:

> "By way of example the following factors may be mentioned, *the order being of no consequence to the weight that should be attached to the factor* in question:
> (1) available residence,
> (2) residence of wife and children,
> (3) relatives,
> (4) duration, regularity and frequency of residence in the various states,
> (5) in the service of one state and residence in another,
> (6) citizenship,
> (7) social attachment,
> (8) capital investment,
> (9) earnings.

[1027] Only the States in which the domestic laws have been modified are able to exclude dual resident losers from domestic and thus treaty residence, see Canada in Brooks, supra note 127, at pp.438-439; and the United Kingdom, see Hji Panayi, supra note 126, at p.883. This is also the case of France, see Delattre, supra note 125, at p.203; the United Kingdom, see FA 1994 Section 249(1); and Canada, see Income Tax Act, section 250(5).

[1028] Van Raad in fact proposes that the addition may have been made to avoid access to the treaty networks of both States, see van Raad, supra note 55, at p.188. See also Boccardo, supra note 427, at p.129.

[1029] See Chapter 7, at pp.84ff; and in relation to the particular issue of abuse, see Chapter 10, at pp.156.

[1030] According to Sasseville "Paragraphs 2 and 3, however, only have effect for the purposes of the treaty. They do not affect the domestic-law status of the resident", see Sasseville, supra note 58, at p.45.

[1031] Moreover, this approach has another undesirable and inevitable effect, which is the exclusion of residents of States applying a territorial system of taxation, see Chapter 7, at pp.91ff.

> The determination should thereupon rest on the weighing and testing of the said, and possibly other, factors and their mutual importance; a determination which, if occasion should arise, may be difficult, indeed impossible."[1032]

While due consideration was given to the possibility of applying the diverse tests conjunctively, and regardless of the undeniable advantages this option presents in terms of quality of the argument, the OECD opted for establishing a hierarchy of tests, to be applied one by one, in isolation. One cannot simply advance in the chain if a certain test does not serve to break ties[1033]. The Model itself explains the mechanism for their application.

The Model also deals with the meaning of the expressions contained in it. As was stated earlier in this section, the spirit of the Model and the policy objective behind the rule of Art.4(2) OECD MC is to establish a treaty definition of residence. For that to occur the terms used to break ties must be provided an international fiscal meaning. In that context, the Commentaries to the Model provide several elements to attribute their meaning to these terms, which are examined in the following lines.

12.3.2. The tie-breakers: Brief history and definition

12.3.2.1. Permanent home[1034]

In the first place in the hierarchy, Art.4(2)(a) OECD MC considers the "place where the individual owns or possesses a home"[1035]. In 1957, Working Party 2 defined 'permanent home' as follows:

> "In the case of a physical person, to the country in which he has his permanent home, that is to say, the centre of his vital interests, or, in other words, the place with which his personal ties are closest."[1036]

Historically, the term 'permanent home' was defined by reference to the personal connections an individual had in a certain State. Accordingly, a German proposal referred to the term as "permanent dwelling"[1037], while France understood the criterion to signify "the place where an individual lives with his family"[1038]. This conception of the term, however, changed with the passage of time. At a certain point and probably motivated by the Delegation for Switzerland[1039], in its Fourth Report Working Party 2 mentioned the tests separately[1040].

By 1972 it was clear in the Commentaries that the meaning of 'permanent home' was limited to a physical place, that is, a physical construction where a person could spend time, like a house or an apartment, located in one of the Contracting States. Instead of referring to his personal relations, the term was restricted to the existence and availability of a house or other similar installation,

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[1032] FC/WP2(56)1, at p.3.
[1033] Italy, Corte di Cassazione, 4 April 2000, *Case 4112*, IBFD case law.
[1034] See also the detailed analysis of the term by Makovníková, supra note 1003.
[1035] Sec.12 of Comm. to Art.4 OECD Model Convention (2014).
[1036] FC/WP2(57)1, at p.2 and at p.6.
[1037] TFD/FC/17, at p.1.
[1038] TFD/FC/216, at p.5.
[1039] The Delegation for Switzerland highlighted this in 1957: "The practice is generally to refer to the circumstances of having a permanent home available in a State. But, as this criterion is not always identical with that of the centre of vital interests, the latter should also be mentioned", see FC/WP2(57)2, at p.6. A proposal by the Delegation for Germany moreover referred to "permanent dwelling" and then, as a separate test, to the "centre of vital interests", see TFD/FC/17, at p.1.
[1040] FC/WP2(57)3, at p.2.

defined as 'home'[1041]. Instead of defining the place through the existence of personal relations, it was the existence of the place itself which gave notice of those ties[1042].

Under the current Commentaries, such a home has been defined in very broad terms. It may take a number of forms, from a house or apartment belonging to or rented by the individual, for instance, to a rented furnished room[1043]. According to this broad concept, even a furnished room in a residence of a family member, or a home owned by a corporation of which the taxpayer is a shareholder may qualify as a 'permanent home'[1044]. What really matters is not the kind of home, but rather that the individual "must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration"[1045]. The expression 'permanent', in other words, is meant to portray the fact "that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which [...] is necessarily of short duration"[1046]. The temporal dimension of the term, that is, the fact that such home needs to be 'permanent', excludes cases of use for limited periods[1047]. Further, the fact that the home needs to be 'available' means that the person must reserve the ability to use that place[1048] regardless of any legal title[1049], whenever he decides.

To sum up, the criteria contained in the 'permanent home' definition aims to identify a location where it is likely that the individual will spend time because of having a dwelling, a place, or a facility available to him to do so. Considering that the OECD made an express decision to exclude personal aspects from the 'permanent home' test and to create a separate rule to take them into consideration, it is fair to conclude that one does not need to demonstrate the presence of actual personal or economic ties with the State in which this home is possessed[1050]. On the contrary, to overcome the test, all an individual needs to do is to provide evidence that there is a location which, in a continuous manner, is available to him to spend as much time as he desires, even if this

[1041] See CFA(71)10(Corrigendum), at p.3. This coincides with the current drafting of the Commentaries, see Sec.13 of Comm. to Art.4 OECD Model Convention (2014).

[1042] Makovníková observes that the consideration to personal attributes in the 'permanent home' criterion generates an overlap that is not harmful between this concept and the 'centre of vital interests' criterion, see Makovníková, supra note 1003, at p.28. This, however, does not coincide with the policy objective pursued by the OECD when differentiating between these two concepts, as illustrated by the history of the Model.

[1043] Sec.13 of Comm. to Art.4 OECD Model Convention (2014). The Netherlands Supreme Court ruled that a hotel room could constitute a permanent home, see The Netherlands *Hoge Raad*, 21 February 1973, BNB 1973/96.

[1044] Makovníková, supra note 1003, at p.31. The notion, however, is not without limits. The lack of a lease agreement or the failure to demonstrate the payment of rent may render the argument of the establishment of residence meaningless, see Canada, Tax Court, 8 April 2005, *Allchin v. Her Majesty the Queen*, 2005 TCC 476, at para.43.

[1045] Sec.12 of Comm. to Art.4 OECD Model Convention (2014). This is mainly the reason why holiday homes are often rejected as apt to constitute residence for treaty purposes, despite the fact that the answer to the question of whether these homes can be regarded as permanent homes must be observed on a case-by-case basis, see Makovníková, supra note 1003, at pp.23-24.

[1046] Sec.13 of Comm. to Art.4 OECD Model Convention (2014).

[1047] Vogel, supra note 6, n.71, at p.247.

[1048] Makovníková uses some interesting examples to illustrate the concept of availability. By way of illustration, the fact that a person may sublet his place to somebody else presents evidence of the place not being 'available' to him *at all times*, see Makovníková supra note 1003, at pp.32-33.

[1049] To Vogel, "actual power of disposition [...] encompasses both the right which the master of a house has and the right of its owner or tenant to determine occupancy of the dwelling", see Vogel, supra note 6, n.71a, at p.248.

[1050] According to Vogel, it is the personal link with the accommodation that demonstrates how intense is the connection with any of the contracting States, see Vogel, supra note 6, n.70, at p.247. Further, Arnold has commented some New Zealand case law where the court defined the 'permanent home' broadly, in relation to the taxpayer's personal relations, see Arnold, Brian, 'Tax Treaty News', in 66 *Bulletin for International Taxation* 9 (2012), at p.481.

never actually happens[1051]. In other words, it is the existence of a home that gives notice of a person's ties, and not the other way around.

12.3.2.2. Centre of vital interests

As was mentioned before, the history of the Model suggests that, for years, permanent home and centre of vital interests were one and a single test. Under one of the first versions of Art.4 OECD MC, the tie-breaker for individuals established:

> "Where a person is fully liable to taxation in more than one Member country, the right to tax shall belong:
>
> (1) in the case of a physical person, to the country in which he has his permanent home, that is to say, the centre o his vital interests, or, in other words, the place with which his personal ties are closest."[1052]

When the OECD established the need to look at those ties through a separate test, the question immediately arose as to the nature of the relation to be portrayed by them. In particular, the Delegation for Germany introduced the question of whether the economic dimension of the link needed to be considered[1053]. Working Party 2, however, was not of that opinion:

> "As will be seen, *only the taxpayer's personal attachment is taken into consideration, whereas the economic one is disregarded*. If the attachment is mainly an economic one, it will be natural for the country concerned to make good its claim to tax by means of a tax at the source, which is also gradually becoming common practice."[1054]

The early history of the test is clear in terms of excluding any consideration to the economic dimension of the person:

> "The proposals made, which attach decisive importance only to the personal relations, appear to the Working Party to provide the clearest solution. A criterion which has to take both personal and economic relations into consideration is more difficult to handle, because the personal relations may be found to be as strong with the one State as the economic relations are with the other [...]. It may further be stated that *it seems natural to leave out economic interests here, as one ought not really to attach any great importance to these considerations for the solution of the double domicile conflict*, the State in which an individual predominantly has economic interests being able to tax at the source the incomes derived from it."[1055]

It is interesting to highlight that the economic dimension of the individual was not to be considered when attributing its meaning to the term 'centre of vital interests' because, as will be explained below, according to the OECD taxation on the basis of an economic nexus was predominantly *source* taxation[1056]. In that context, a person's economic activities needed to be ignored when breaking a tie between two claims of residence. The obvious difficulties derived

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[1051] It is interesting to notice that courts have ruled the presence of a permanent home in cases in which the relevant taxpayer has abandoned the State, if he has retained his home and the possibility exists for him to come back to it, even only to visit. After examining such case law, Makovníková observes that "the length of the individual's stay in a house or regular use of the house should not be given too much weight in determining the permanency. It might be argued that it is not the use which must be permanent, only the availability", see Makovníková, supra note 1003, at pp.22-23. Moreover, she concludes that the intentions of the taxpayer towards this home should also not be taken into consideration, see Makovníková, supra note 1003, at pp.26-27. Arnold has commented the *Trieste* case in Canada, where the 'permanent home' criterion was fulfilled because the taxpayer retained his home in Canada and visited only once a month, see Arnold, Brian, 'Tax Treaty News', in 67 *Bulletin for International Taxation* 3 (2013).

[1052] FC/WP2(57)1, at p.2.

[1053] A proposal by the Delegate for Germany referred to "permanent dwelling" and then, as a separate test, to the "centre of vital interests", see TFD/FC/17, at p.1.

[1054] Emphasis added, see FC/WP2(57)1, at p.6.

[1055] FC/WP2(57)3, at p.8.

[1056] This idea is examined in detail some paragraphs below, at pp.199.

from having personal and economic relations with different States[1057] finally tipped the balance towards fully disregarding the latter.

The discussion, however, did not end there. The need to consider the economic dimension of the person was further analysed[1058] and, despite the OECD's initial unwillingness, in 1958 the Commentaries were changed to include these economic activities as part of the term "personal relations"[1059]. At the outset, the expression "economic relations" was added to the Model itself some months later[1060].

Under the current Art.4(2)(a) OECD MC the 'centre of vital interests' test is essentially different from the 'permanent home' test, and considers the personal and economic relations of the individual:

> "If [the individual] has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests)."[1061]

One cannot but observe that the test needs to be applied exclusively if the relevant taxpayer is found to have a 'permanent home' in both contracting States[1062]. If this were not the case, the place of 'habitual abode' needs to be ascertained[1063]. Bearing in mind that this test aims to determine the State with which the individual who possesses a permanent home in both States has closer personal and economic relations, the Commentaries further clarify:

> "[…] regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The *circumstances must be examined as a whole*, but it is nevertheless obvious that considerations based on the *personal acts of the individual must receive special attention*. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in that State."[1064]

The personal dimension involved in the 'centre of vital interests' encompasses "a taxpayer's entire way of life"[1065]. However, the opinion of the taxpayer in order to explain his relation with a given

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1057 Raised by the Delegation for France: 'Now the case where a person has his "persona relations" in one State and his "economic relations" in another State is very frequent and is likely to happen more and more often. It therefore seems to the French Delegation that to unite these two categories of "relations" to determine the centre of vital interests will not prove to be quite adequate but it has not for the moment found any satisfactory solution that it can propose for the attention of the Fiscal Committee", see TFD/FC/216, at pp.5-6.

1058 DAF/FC/71.5, at p.3.

1059 They "covered both family and economic connections", see FC/M(58)I, at p.3. This was finally added to the Commentaries in 1958, see FC(58)2(1st Revision) Part II, at p.18.

1060 'The Committee adopted the text of the draft Article on fiscal domicile […] with the following amendments: in paragraph II-1, add in the first subparagraph the words "and economic" after the word "personal" (with a corresponding amendment in the Commentary)', see FC/M(58)2, at p.5.

1061 Art.4(3)(a) OECD MC, and Sec.14 of Comm. to Art.4 OECD Model Convention (2014).

1062 When taking care of some observations by the United States Delegation in relation to the taxation of estates and inheritances, Working Party 17 stated: "It is, in fact, inconceivable that a deceased could have his centre of vital interests in a State […] without having there a permanent home, this being represented by any form of dwelling that was continuously available to him", see TFS/FC/178, at p.3.

1063 The UK Delegation raised the question as to the appropriateness of this logic in 1967, see TFD/FC/216, at p.5.

1064 Emphasis added. Sec.15 of Comm. to Art.4 OECD Model Convention (2014).

1065 Vogel, supra note 6, n.74, at p.249.

place is irrelevant[1066]. On the contrary, if any consideration is given to his intentions, they must be considered objectively[1067].

Given the literality and the history of the Commentaries, regardless of the intention of the OECD, it is clear that an interpretation of the 'centre of vital interests' test in a way in which the personal activities of the taxpayer are preferred over his economic ones seems inevitable. Although the circumstances of the taxpayer need to be examined as a whole[1068], policy considerations inherent to the tie-breaker and to the definition of residence indicate that the personal aspects of the definition are preponderant[1069]. The economic dimension of the person is, under the OECD's approach, more likely to be covered by the consideration to source taxation, as will be emphasised in section 12.3.3 below, and it is not necessarily relevant for the purposes of breaking the residence tie.

12.3.2.3. Habitual abode

According to the history of the Model:

> "If the country in which [the individual] has his permanent home cannot be determined [...] the right to tax shall belong to the country in which he principally resides."[1070]

Often referred to as 'length of stay'[1071], 'principal abode'[1072], or 'continuing abode'[1073], the term 'habitual abode' was used in the context of the Model for the first time in 1958[1074]. Under the rules of the OECD MC, if the individual possesses a permanent home in both contracting States and it is impossible to determine in which one his centre of vital interests is located, or if the individual possesses a home in neither contracting State, Art.4(2)(b) OECD MC breaks the tie by reference to the State in which the individual has a 'habitual abode'[1075].

According to the Commentaries, if that were the case this "tips the balance towards the State where he stays more frequently. For this purpose, regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State"[1076]. The same applies to individuals who do not have a permanent home in any of the States: "In that case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them."[1077]

1066 Although Schwartz has stated that an election by the taxpayer is "likely to be no less arbitrary than where the competent authorities decide", see the comments by Schwartz in Avery Jones et al., supra note 86, at p.664.

1067 The Netherlands *Hoge Raad*, case number 24.142, BNB 1990/101.

1068 Some courts have grounded entire rulings on possession of assets, for instance, see Rotondaro, supra note 963, at pp.387-388. According to Pittman, this statement would allow the conclusion that one needs to define whether, for a certain individual, personal or economic activities are more important, see Pitman, supra note 1004, at pp.46-47.

1069 Some courts have been obedient in following these guidelines. Avella, for instance, analyses some EU case law to demonstrate how courts prefer personal over economic interests when defining the term, see Avella, Francesco, 'Using EU Law To Interpret Undefined Tax Treaty Terms: Article 31(3)(C) Of The Vienna Convention Of The Law Of Treaties And Article 3(2) Of The OECD Model Convention', 4 *World Tax Journal* 2 (2012), at p.121. Arnold carries out a similar analysis in relation to some New Zealand rulings, see Arnold, Brian, 'Tax Treaty News', in 66 *Bulletin for International Taxation* 9 (2012), at p.481.

1070 FC/WP2(57)1, at p.2.

1071 FC/WP2(57)1, at p.6.

1072 Delegation for Switzerland, FC/WP2(57)2, at p.6.

1073 FC/WP2(57)3, at p.2.

1074 FC/M(58)I, at p.9.

1075 Sec.16 of Comm. to Art.4 OECD Model Convention (2014).

1076 Sec.17 of Comm. to Art.4 OECD Model Convention (2014).

1077 Sec.18 of Comm. to Art.4 OECD Model Convention (2014).

The criterion involved in the habitual abode test is essentially temporal[1078], as it implies a comparison between the stays in both States claiming the right to tax on the basis of residence. Yet this does not mean that the stay itself can be temporary. On the contrary, the word 'habitual' indicates the need of regularity or frequency in relation to the stays in one State[1079]. Moreover, the length of the stay is not in itself relevant because the Model "does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place."[1080] The comparison the test implies is, in fact, not even limited to the same taxable year[1081].

It appears that this temporal criterion is not restricted to one in which days must simply be counted but it seems to refer, more broadly speaking, to the place in which a person normally lives[1082]. Bearing this in mind, some authors have argued that the comparison must be made by taking into consideration several elements, such as the *animus* of the taxpayer towards the place[1083]. This would imply that the temporal absences of the taxpayer would not be relevant if he retains the intention to come back to this place, where his normal life is carried out. Such a conception of the 'habitual abode' test, however, would clearly generate an overlap with the centre of vital interests[1084], which does not seem to be the intention of the OECD when establishing separate tests to measure different kinds of connection with a given State. The purpose of the habitual abode test, considering its history, is to only decide which of the States in which a personal and economic connection cannot be clearly defined has the right to tax, on the basis of where the taxpayer stays more frequently. This cannot possibly mean that beyond the length and frequency of the stays any personal attachment with the relevant State must be demonstrated in order to comply with the test[1085].

12.3.2.4. Nationality

[1078] For a detailed explanation of the scope of the term 'habitual abode' see Barrera Vasquez, Marco Antonio, 'The limits of habitual abode and nationality tie-breaker rules in the OECD Model Convention', in Hofstätter, Matthias, Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at pp.65-72.

[1079] Barrera Vasquez, supra note 1078, at p.67.

[1080] Sec.19 of Comm. to Art.4 OECD Model Convention (2014). This was a decision, see CFA(71)10(Corrigendum), at p.5.

[1081] Arnold, supra note 1069, at p.481.

[1082] Vogel, supra note 6, at p.253; Avery Jones et al., 'Dual Residence of Individuals: The Meaning of the Expressions in the OECD Model Convention – II', in 1 *British Tax Review* (1981), at p.116. See also Tax Court of Canada, *Allchin v. R*, 2 CTC, 2701, [2008], commented in Stacey, M., 'Habitual abode in Tax Treaties', 13 *Canadian Tax Highlights* 7 (2005), at pp.4-5; Canada, Tax Court, 29 September 2009, *Lingle v. R.*, 2009 TCC 435, in particular at para.28-30, commented in Arnold, supra note 1069, at pp.373-374. It appears, however, that most courts only count days: "During 1990, petitioner spent only 120 days in Montreal; he spent the remainder of the year in the United States, including 160 days in Florida and 50 days in South Carolina. Because petitioner spent more time in the United States […] it appears that petitioner had a habitual abode in the United States", see United States, Tax Court, 18 November 1998, *Stephen Podd, et al. v. Commissioner*, TC Memo 1998-418 Stephen D. Podd, et al. In a Canadian case, evidence showed that the taxpayer "spent more time in Korea than in Canada in 2001. Therefore, her habitual abode was in Korea and not Canada", see Canada, Tax Court, 22 July 2005, *Yoon v. Her Majesty the Queen*, 2005 TCC 366, at para.41.

[1083] Vogel has in fact explained that the term is meant to complete the meaning of the 'centre of vital interests' test, in the sense of permitting the election of the place with which the taxpayer's ties are closest when the centre of vital interests is unclear, see Vogel, supra note 6, at p.252.

[1084] Pittman, supra note 1004, at p.54.

[1085] "This expression should be interpreted literally, i.e. where the individual lives the longest and why he stays there – holidays, professional or personal reasons – and where he stays – hotels, flats or houses – is irrelevant", see Nuñez, supra note 240, at p.532.

According to Art.4(2)(c) OECD MC, "if [the individual] has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national."[1086] The test of nationality only applies if the habitual abode fails to break the tie. While there is not much to say in relation to this test[1087], it may be relevant to emphasise that the conditions to become a national are essentially a domestic concern, and they cannot be appreciated from any other perspective than that of the constitutional laws of the alleged State of residence[1088].

12.3.2.5. Mutual agreement procedure

According to Art.4(2)(d) OECD MC, "if [the individual] is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement"[1089]. In this sense, it is relevant to highlight that the possibility of reaching an agreement as to how the tie needs to be broken is not precisely left to the judgment of the States. According to the rule they *shall* find a way of breaking the tie[1090], and thus permit the application of the Model.

12.3.3. Nature of the connection in the tie-breaker for individuals

The character and essence of the links that the Model define as relevant for the purposes of breaking the tie appear to be distant from the economic dimension of the person involved[1091]. In the case of a 'permanent home', there is little to verify beyond the existence of a *locus* that is apt for the individual to live, even if he has ceased to use it. Even in the case of the 'centre of vital interests', in which some sort of an economic component may actually be noticed, it is clear that such dimension is only secondary, compared with the personal aspects of the link a taxpayer must have with a State in order to break the tie. A similar observation can be made in relation to a person's 'habitual abode', which is no more than a temporal measure to determine in which State he spends more time. Whether this indicates with which State he has a stronger economic nexus, or where he produces most of his income, is a totally different question.

This, however, should not be striking, insofar as it is based on a fundamental and calculated policy decision made by the OECD when drafting Art.4 OECD MC:

> "When determining which state is to be given preference, importance may be attached to the facts indicating the state with which the person concerned has:
>
> (1) the stronger economic relations, or
> (2) the stronger economic and personal relations, or
> (3) the stronger personal relations.

1086 Sec.20 of Comm. to Art.4 OECD Model Convention (2014).
1087 See Barrera Vasquez, supra note 1078, at pp.74-77.
1088 Vogel, supra note 6, n.81, at p.253. Avery Jones observes that, amongst the elements in Art.4(2) OECD MC, nationality is the only one which needs to be defined under domestic rules. Whether this equates to stating that nationality as a tie-breaker must be defined autonomously by the contracting States, that seems to be a different issue, see Avery Jones et al., supra note 1002, at p.19.
1089 According to Art.25 OECD MC, see Sec.20 of Comm. to Art.4 OECD Model Convention (2014).
1090 Vogel, has referred to this as an "obligation to reach agreement", see Vogel, supra note 6, n.82, at p.254.
1091 Despite the fact that, to some, individuals would have the need of establishing "a real social and economic presence in a state in order to become residents", see Duff, supra note 157, at p.77. Maisto has explained that the election of the criteria for individuals 'was based on "fair", and traditionally recognised standards which rely on sound personal attachments of the individual to the state', Maisto, supra note 538, at p.47. It is interesting to consider the views of Sadiq when analysing "physical presence as opposed to economic activity", see Sadiq, supra note 162, at pp.184-186.

Gradually, as the various states have embarked on taxation of income originating from sources in the state concerned and through such procedure tax on the basis of an economic attachment, it appears natural, as far as natural persons are concerned, *to leave possibility (1) out of consideration*, so that the choice will be between a consideration of the personal attachment of the taxpayer concerned alone or of his personal as well as his economic attachment."[1092]

Under the reasoning behind the tie-breaker, because *source* taxation is imposed on the basis of an effective economic presence (giving credit to the economic activities of the taxpayer), the system of residence must not and cannot follow the same line[1093]. Residence must be defined by considering the economic activities of the relevant taxpayer as little as possible. Yet, it is more or less evident that focusing only on personal aspects of the treaty claimant makes the test quite easy to manipulate from a treaty abuse point of view, which is a recurrent question nowadays. These concerns, however, are not new. They were raised by the United States Delegation, when discussing the application of Art.4 OECD MC in the field of estates and inheritances, as early as in 1965:

> 'If domicile is to serve as a basis for determining jurisdiction to impose estate and inheritance taxes, it is important that the tests which determine the state of domicile be realistic and meaningful and not subject to artificial manipulation by taxpayers to their own advantage. Article 4 falls short in this respect in giving an undeserved importance to the place where one has had a "permanent home available". This would invite a taxpayer whose "centre of vital interests" is in State A, a country with high death duties, to keep a "permanent home available" in State B, a country with low death duties. Even though the taxpayer spent most of his time in State A, so long as he was careful always to stay in hotels and furnished apartments in State A without having any "permanent home available" there, on his death his intangible personal property would be subjected only to the low death duties of State B. […]
>
> To avoid this result, Paragraph 2(a) should be deleted. Priority could then be given either to the "centre of vital interests" […] or to "habitual abode". As described in Paragraphs 20-22 of the Commentary, the concept of "habitual abode" is a realistic one which gives due recognition to all visits in a State, without regard to the reasons for such visits or the type of accommodations occupied by the decedent while he was visiting. However, *it would be consistent with the preference for home over economic ties which is reflected in the present draft to give priority to "habitual abode" rather than to the "centre of vital interests".*'[1094]

While the policy considerations at the heart of the tie-breaker for individuals may be questioned from a treaty abuse point of view, it should not be surprising to find oneself in situations in which the interpretation of the tie-breaker results in the facilitation of treaty abuse. After all, the economic dimensions of a person, amongst them, his economic activities, play only a secondary role, at best, when breaking the tie in cases of individuals[1095].

1092 Emphasis added. FC/WP2(56)1, at p.4.

1093 To some these changes represent "a step towards the source taxation principle", see Romano, Carlo, 'Italy. The Evolving Concept of "Place of Effective Management" as a Tie-Breaker Rule under the OECD Model Convention and Italian Law', in 41 *European Taxation* 9 (2001), at p.343.

1094 Emphasis added. These draft rules represented the views of the United States Delegation in relation to taxes on estates and inheritances, see TFS/FC/178, Annex. Views of the United States Delegation on the Seventh and Eight Reports of Working Party Nº 17 on Taxes on Estates and Inheritances, at pp.8-9. Working Party 17 however dismissed these arguments: "It is, in fact, inconceivable that a deceased could have his centre of vital interests in a State […] without having there a permanent home, this being represented by any form of dwelling that was continuously available to him", see TFS/FC/178, at p.3.

1095 Avery Jones seems to have recognised this when proposing the addition of a tie-breaker according to which residence of an individual is recognised to be in the State in which a greater amount of his income is located. This was supposed to operate as "a proxy for closer economic relations". The test, however, was only considered as an alternative to the permanent home, and a 183 nights in the relevant State test, see the comments of Avery Jones and his proposal for a new tie-breaker in round table, Avery Jones et al., supra note 86, at p.656. Schwartz, on the other hand, suggested that "the rule must give priority to the substance of residential connecting factors over formal elements", although it is not clear whether this actually happens, see Schwartz comments in Avery Jones et al., supra note 86, at p.659.

12.4. Tie-breaker for persons other than individuals in Art.4 (3) OECD MC

12.4.1. Introduction: The 2015 changes to the tie-breaker for entities

In 2015, some relevant changes were proposed to Art.4(3) OECD MC. While the old version of the rule breaks the entity residence tie by giving preference to the State in which the place of effective management is situated, the modified version operates on the basis of a different test. This new test takes into consideration multiple other dimensions of the existence of those entities.

Regardless of the fact that the new version of the tie-breaker will settle any ties occurring under the new version of the Model, it is a fact that, under multiple tax treaties currently in force, the place of effective management test still persists. An effort will therefore be made, in the following lines, to explore both the current version of the entity tie-breaker, using the place of effective management test, and the modified version of it, introducing a new entity tie-breaker.

12.4.2. The tie-breaker for entities before 2015: Place of effective management

12.4.2.1. History: The fragile background of the tie-breaker for entities[1096]

The idea that a dual residence conflict in the case of entities may be rare in practice is a very old one, and it can be traced back to the beginning of the discussions at the OEEC[1097]. This is perhaps the reason why the issue was never taken really seriously. As a matter of fact, if one examines the history of the dual residence test for entities, the process, which ended up in the inclusion of the place of effective management test to Art.4 OECD MC, is quite disgraceful.

In 1956, the essence of the issue was described by WP2:

> 'The fact that the London Draft Convention attaches importance to "the real centre of management" must presumably be seen as an expression of the view that the determination must be made on the basis of considerations of facts and not merely on the basis of a formal registration. The term "real centre of management" and similar terms suffer, however, from the defect that they are not exact and that the question may be raised whether the real management of a joint-stock company is the general meeting (i.e. shareholders), or the board of directors or the managers.'[1098]

In parallel to the work of WP2, WP5 was in charge of the rules on taxation of income and capital of shipping and air transport enterprises[1099]. In that context, it was concluded that some conventions assigned the right to tax to the State in which the company's place of management was situated, while others focused on the place of effective management, or on the place of fiscal domicile or 'residence'. However, WP5 had a clear opinion on which test was the most appropriate:

[1096] Sasseville and Vann have explored in detail other aspects of the history of the place of effective management test, see Sasseville, Jacques, 'The meaning of "place of effective management"', in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at pp.287-301; and Vann, supra note 41, at pp.209-243.

[1097] FC/WP2(56)1, at p.4. This has been debated: "other than stated in the Commentary, it is not rare in practice for a company to be subject to tax as a resident in more than one State", see van Weeghel, Stef, 'Article 4(3) of the OECD Model Convention: An inconvenient truth', in Maisto, G., (ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2009), at p.304. Under the Commentaries updated in 2015, the mention subsists, see OECD, Action 6: 2015 Final Report, supra note 1, at p.73.

[1098] FC/WP2(56)1, at p.5.

[1099] FC/WP5(56)1.

'[…] both the "place of effective management" and "fiscal domicile" can equally be regarded as offering an acceptable solution. Nevertheless, it seems that the principle of reserving the power to tax shipping or air transport enterprises to the State in which the effective management is situated should be regarded as being the *safer, and simpler in application*. […] One might therefore envisage using this formula in preference to the other.'[1100].

Without wasting too much time, after only two months WP5 expressed that the main reason to opt for the 'place of effective management' was the uncertainty as to the definition of 'fiscal domicile', a term which was still being elaborated by WP2:

'Another reason why the Working Party would like to keep the rule of "effective management" is the present uncertainty about the rule of "fiscal domicile". We do not know yet if or when we can come to an agreement about "fiscal domicile". If the Committee prefers the rule of "fiscal domicile", the whole question about taxation of shipping, etc. must be postponed until a decision is made on the report of Working Party No.2'[1101]

It is curious, to say the least, to notice that the 'place of effective management' test was chosen by WP5 in relation to shipping and air transportation because of the primitive stage in which the debate in relation to 'fiscal domicile' was. This is so because afterwards, when the time came to select the criteria for breaking the tie in the case of entities, the fact that the 'place of effective management' was used for the purposes of Art.8 OECD MC was regarded as highly relevant by WP2 to make such a crucial election:

'While discussing this question of the formulation of the preference criterion in the case of corporations, the Working Party takes the opportunity of calling attention to the Report […] submitted by Working Party No.5 on the taxation of income and capital of shipping and air transport enterprises. […] In its former reports Working Party No.2 proposed to adopt as a preference criterion the term used in the Conventions concluded by the United Kingdom: "where its business is managed and controlled". As it has been stated that this term means the effective management of the enterprise, and as it must appear natural to use the same criterion in the two Articles, the Working Party now proposes the same formula in paragraph (2) as proposed in the Article on shipping and air transport enterprises.'[1102]

By November 1957 it was relatively clear that WP2 had chosen the 'place of effective management' test as a tie-breaker for entities, and so it appeared in the proposed draft article[1103]. According to the 2014 version of the Commentaries[1104]:

"The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport."[1105]

'As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals.'[1106]

It is interesting to notice that the Delegation for Greece carried out a strong defence of the principle of 'fiscal domicile' instead of the 'place of effective management' test in relation to

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1100 Emphasis added, FC/WP5(56)1, at pp.5-7. At a later stage the place of effective management was described also as "more consistent with the realistic character of taxing legislation", see FC/WP5(57)2, at p.14. In none of those opportunities were any reasons given to sustain the convenience of that test.

1101 FC/M(56)2(Prov.), at p.10. This was a prevalent argument used by WP5 in front of the Fiscal Committee to choose the 'place of effective management' test, see FC/WP12(58)1, at p.3.

1102 FC/WP2(57)3, at p.9.

1103 FC/WP2(57)3, at p.2.

1104 FC/WP2(57)3, at p.2.

1105 Sec.23 of Comm. to Art.4 OECD Model Convention (2014). The first version of these Commentaries can be traced to 1958, see FC(58)2(1st Revision) Part II, at p.19.

1106 These Commentaries disappeared as a consequence of the BEPS project, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.80; and OECD, Action 6: 2015 Final Report, supra note 1, at p.72.

income from shipping and air transportation activities. When one reads the arguments presented to the Fiscal Committee, it appears that the objection really aimed to criticising the OECD for trying to favour the consolidation of New York and London as the main shipping centres at that time, by using the 'place of effective management' test in its model convention[1107]. In any case, considering the depth of the analysis behind the inclusion of the 'place of effective management' as a tie-breaker, the number of problems derived from its use should not be striking.

12.4.2.2. 'Place of effective management' under the OECD MC before the BEPS project

The Commentaries to Art.4(3) OECD MC before the changes proposed in 2015 in the context of the BEPS initiative define the 'place of effective management' in the following manner:

> "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are *in substance* made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time."[1108]

Considering the need to define the term at the treaty level[1109] the OECD provides some guidelines[1110]. Firstly, the definition refers to a 'place'. This means that a physical location from where management is exercised must be identified[1111]. Secondly, this place is relevant because in it, key management and commercial decisions are made[1112]. The crucial character of such decisions is determined by the fact that they are vital for the conduct of the entity's business *as a whole.* Thirdly, according to the concept, one needs to look at the place where these decisions are made *in substance*. This seems to suggest that it is not enough to ascertain the place where, for instance, the board of directors meet, but rather one needs to identify whether those decisions are actually made by that board, or by other person instead. Finally, according to the guidelines set out in the Commentaries, it is clear that even though a company may have multiple places of management, there will only be one place of *effective* management, meaning "realistic, positive management"[1113], at any one time.

This definition has been controversial. It was modified in 2000, when the OECD tried to explain the rules to identify this place in the Commentaries[1114], and then again only eight years later, in 2008, when those changes were reversed[1115].

1107 See FC(58)4, at pp.2-3. Greece, in fact, introduced a reservation on Art.8 OECD MC, reserving its right to settle the question of income from shipping and air transportation activities through bilateral negotiations, see FC/M(58)4, at pp.4-5, and the acceptance of the Fiscal Committee of these observations in FC(58)5, at p.7. Under the current Commentaries, that reservation can no longer be found.

1108 Emphasis added. Sec.24 of Comm. to Art.4 OECD Model Convention (2014).

1109 In words of Sasseville: "I personally think that the treaty context requires a common interpretation of the concept", see Sasseville, supra note 1096, at p.299.

1110 It has been suggested that these guidelines set out a concept which cannot be identified with the Anglo-American term 'central management and control', or with the continental European concept of 'place of management', see Burgstaller, Eva and Haslinger, Katharina, 'Place of Effective Management as a Tie-Breaker-Rule – Concept, Developments and Prospects', 32 *Intertax* 8/9 (2004), at p.386.

1111 For some negative effects of focusing too much on the *place* see Vogel, Klaus, 'Tax Treaty News', in 53 *Bulletin for International Taxation* 3 (2005), at p.418.

1112 According to Vogel, what is "decisive is the not the place where the management directives take effect but rather the place where they are given", Vogel, supra note 6, n.105, at p.262.

1113 "The place of effective management is where the shots are called, to adopt a vivid transatlantic colloquialism", see Sec.7, para.2, United Kingdom, Special Commissioners, 14 March 1996, *Wensleydale's Settlement Trustees v. Inland Revenue Commissioners*, IBFD case law.

1114 2000 addition: "The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by

12.4.2.3. Difficulties with the term 'place of effective management'

At the origin of the Model, the basic tie-breaker problem in the case of entities was *incorporation vs. management*. The 'place of effective management' test was chosen in comparison to registration, which according to the OECD was too easy to manipulate[1116]. The idea behind the test was to attribute the right to tax on the basis of residence to that State in which the fundamental decisions related to the administration of an entity were *in substance* made.

If one looks closely at the rules of the Model, it is interesting to note that this is as far as the solutions contained in it go. In other words, the rules are restricted to solving the question of whether incorporation or management is a more convenient criterion for breaking ties in the case of entities. While one may understand, as the OECD does, that this election implies the triumph of *substance over form*[1117], it is relatively evident that the questions posed by the use of the place of effective management in this particular field are significantly more complex.

As early as in 1964, the Delegation for Japan noticed:

> 'If a Contracting State adopts the "place of effective management" criterion in its domestic law, and the other Contracting State adopts another criterion such as the place of incorporation, a company incorporated in that other Contracting State and effectively managed in the first-mentioned State, is deemed to be a resident of the first-mentioned State under the Draft Convention. In this connection, a company might try to move the place of effective management to a country where the tax burden on company's profits is comparatively small."[1118]

While the observations made by the Japanese Delegation put forward some clear profit shifting concerns, with the passage of time the problems derived from the use of the place of effective management test have become more and more complex.

One author who has fiercely criticised the use of this test as a tie-breaker is van Weeghel. As he has so neatly explained, the issue 'is not so much dual residence as a result of the application of a formal criterion in one State and a substantive criterion in another state [which can be solved

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the entity as a whole are determined; however, no definitive rule can be given [...]", see Sec.24 of Comm. to Art.4 OECD Model Convention (2000).

1115 See OECD, *The 2008 Update to the OECD Model Tax Convention*, (Paris: loose-leaf, 2008), at p.7. Sasseville has explained that the OECD may have reversed these changes because of having gone too close to the Commonwealth's concept of "central management and control", see Sasseville, supra note 1096, at p.294. Avery Jones, however, argues that the difficulties related to the expression have a longer history, see Avery Jones, '2008 OECD Model: Place of Effective Management – What One Can Learn from the History' in 63 *Bulletin for International Taxation* 5 (2009), at pp.183-186. There were strong critics to this new test: "This test is so vague that it seems inevitable that it will be applied inconsistently by various countries, which is especially undesirable for a tie-breaker rule", see Arnold, Brian, 'The 2008 Update of the OECD Model: An Introduction', in 63 *Bulletin for International Taxation* 5 (2009), at p.178. See also the analysis of Plakhin, Yevheniy, 'The Place of Effective Management as a Tie-Breaker Criterion', in Hofstätter, Matthias, Plansky, Patrick (eds.), *Dual Residence in tax treaty law and EC law*, (Wien: Linde Verlag, 2009), at pp.86-92; and Boccardo, supra note 427, at pp.125-133.

1116 "The Working Party considered that it was natural not to attach importance to a purely formal criterion like registration", see FC/WP2(57)1, at p.6; and Sec.27 of Comm. to Art.4 OECD Model Convention (2014).

1117 'Given that the "place of effective management" [issue] is one of substance over form, in theory, it should always produce results which reflect the true policy intention of the tie breaker rule', see OECD, *The impact of the communications revolution on the application of the "place of effective management" as a tie breaker rule. A discussion paper from the technical advisory group on monitoring the application of existing treaty norms for the taxation of business profits*, (Paris: loose-leaf, 2001), at p.8.

1118 TFD/FC/173, at p.4. The Japanese Delegation probably observed what the Commentaries to Art.8 OECD MC prescribed at that time: 'The "place of effective management" of an enterprise carried on by a resident of a Contracting State might be in neither of the Contracting States', see TFD/FC/173, at p.5.

under the current rules of the Model], but the real issues in the modern world are the interpretation of the term "place of effective management" and the determination where the place of effective management is.'[1119] There are, in fact, several obstacles derived from the definition that are quite useful in a tax planning context which, at the same time, pose several difficulties for tax authorities around the globe to ascertain where this place actually is.

The first problem refers to the very definition of an entity. The work of the OECD in the field of hybrid mismatch arrangements has demonstrated that the disparities between the laws of the States and the rules of the Model create weaknesses in dealing with hybrid entities[1120]. Secondly, following the observations by van Weeghel, the OECD MC tends to look at entities in isolation, but this is a world of multinational companies[1121]. A group's administration, often commanded by a board, operates simultaneously, in several cases, with international subsidiaries that are tightly managed domestically. Further, a top holding company may perfectly well be managed by an international board, and not even from a physical place. In both cases, it is quite a challenge to determine who in fact manages the relevant entities. Thirdly, alternatives such as consolidation or joint administration make it really hard to ascertain the place where key management and commercial decisions are in substance made[1122] and, at the same time, they pose serious obstacles to identify which decisions are in fact *key* for a group's businesses as a whole[1123].

Moreover, from a tax treaty abuse point of view, there is the question of whether the test necessitates a minimum standard of relevant substance. The Commentaries state that the place of effective management seeks to identify the country in which key management and commercial decisions are in substance made. Yet it is more or less obvious that this so-called *substance* is not the same one that is relevant in the context of abuse, as a parameter for tax treaty entitlement.

Even if one assumes that the test is not a legal one but a factual one, it is a reality that an entity may be created or modified in order to manipulate it. Places of management have been changed to abuse tax treaties and thus the question of whether the test is formal or factual becomes irrelevant. The test has been incapable of keeping up with economic development, and its flaws are particularly evident if one looks at the issue from the perspective of the evolution of technology.

12.4.2.4. Places of management in the era of modern communications

According to van Weeghel, the presence of electronic commerce is not the ultimate reason why the place of effective management test has collapsed. Its failure is due to the combination of the globalisation of multinational enterprises, the mobility of business executives, the *fungibility* of the shareholder base, and the convergence of share trading platforms[1124]. Despite the undeniable truth behind these statements, additional difficulties for the use of the place of effective

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[1119] See van Weeghel, supra note 1097, at p.304. Sasseville in fact observes that the key issue in relation to the term is to define to what kind of management it refers, see Sasseville, supra note 1096, at p.299.

[1120] The OECD has in fact accepted that, despite the changes to the tie-breaker for entities, some of these distortions will not be solved, see OECD, supra note 820, at p.137.

[1121] Van Weeghel, supra note 1097, at p.305.

[1122] Vogel also mentions company-interlinking contracts, control contracts, management contracts, business leasing contracts, takeover contracts, amongst others, see Vogel, supra note 6, n.108, at pp.263-264.

[1123] "One member considered that one should ignore the management of each office and look for the management of the company as a whole, but another pointed out that the Commentary does not say this", see Avery Jones, John, 'Place of Effective Management as a Residence Tie-Breaker' in 59 *Bulletin for International Taxation* 1 (2005), at p.23.

[1124] See van Weeghel, Stef, 'The Tie-Breaker Revisited: Towards a Formal Criterion?', in Hinnekens, L., and Hinnekens, P., (eds.), *A Vision of Taxes Within and Outside European Borders*, (The Hague: Kluwer Law International, 2008), at p.965.

management test as a tie-breaker derive from the current technological framework. The availability of means of communication has made the determination of this place even easier to manipulate, despite the efforts of tax authorities and courts. The OECD has recognised in the Commentaries to the Model these difficulties:

> "Some countries also consider that such a case-by-case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies."[1125]

In February 2001, the OECD created the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (TAG Group). According to this Group's conclusions:

> "[...] the availability of advanced and evolving communications technology such as videoconferencing or electronic discussion group applications via the Internet means that it is no longer necessary for a group of persons to be physically located or meet in one place to hold discussions and make decisions. In a modern environment, application of the traditional approach can produce results which do not reflect the intention of the tie-breaker rule."[1126]

The proposals by the TAG Group tried to sustain the need to update the entities' tie-breaker test from a policy perspective[1127] in the following manner:

> "In order to achieve a tie-breaker rule that will produce a single territory result in all cases, the following options may be considered:
>
> A) Replace the place of effective management concept.
> B) Refine the place of effective management test.
> C) Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply; or
> D) A combination of B and C above.
>
> Another alternative is to deny dual resident companies the benefits under the Convention. Although this option does not address the issue of residence-residence conflicts resulting in double taxation, it does act as a deterrent to treaty abuse by dual resident companies."[1128]

Amongst these proposals, it is interesting to highlight the one according to which the 'place of effective management' was actually replaced by the "place where economic nexus is strongest". The explanations given by the TAG Group in relation to this particular rule were:

> '59. The economic connection to a State may be characterised by the extent that land, labour, capital and enterprise (the factors of production) are used by the company in deriving its profits. Using those characteristics the tie-breaker would serve to determine to which State, the company has its *strongest ties* and to deem the company to be a resident solely of that State.
>
> 60. While on the surface it may appear that such an option is more aligned to source taxation rationale, it also may have some links to the underlying rationale for residence taxation. It could be argued that if the State provides certain facilities and infrastructure for its residents, those who benefit most from such facilities and infrastructure ought to contribute to the State via residence-based taxes. So if a company uses the legal infrastructure, consumes or uses the facilities etc in that State, there is a case that it ought to be treated as a

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[1125] Sec.24.1 of Comm. to Art.4 OECD Model Convention (2014).
[1126] OECD, *The impact of the communications revolution*, supra note 1117, at p.8.
[1127] "In a modern environment, the application of the above factors may not result in a clear determination of which State should be given preference as the State of residence, or may result in an outcome which does not appear to accord with the policy intentions of the provision", see OECD, *The impact of the communications revolution*, supra note 1117, at p.8.
[1128] OECD, *The impact of the communications revolution*, supra note 1117, at p.10.

> resident. If it does so in more than one State, then a tie-breaker rule based on economic nexus would require a determination (as with individuals) of where its ties/consumption are stronger. However, it could also be argued that the use by a company of the facilities and infrastructure of a State is a rationale that supports source, rather than residence, taxation. Nevertheless, the concept of economic nexus could still be used as a tie-breaker even if it is not used as a basis for residence taxation. It should be noted that such a concept being used in a residence tie-breaker is not unprecedented. For example, the individual tie-breaker uses *"centre of vital interests"* as a determining factor in deeming residence.
>
> 61. It may be that this option warrants further consideration on the appropriateness of such a test to confer residence. If so, the *consideration should be given as to what characterises economic connection to a State.*'[1129]

Moreover, the alternative of establishing a hierarchy of tests, as in the case of the tie-breaker for individuals, contemplated the following criteria:

> "71. The level or levels below would therefore deal with determinations regarded as the exceptions. A possible structure for such a hierarchy may be:
> - Place of effective management.
> - Place of incorporation.
> - *Economic nexus*; and
> - Mutual agreement."[1130]

In May 2003 the OECD published a discussion draft on the basis of the comments received to the above-mentioned proposals[1131]. The alternative of replacing the place of effective management test was not even considered, whereas the possibility of establishing a hierarchy of tests gave place to a proposal for new Commentaries to Art.4 OECD MC. Two aspects of this discussion draft are worthy of consideration: Firstly, that the place of incorporation was erased from the hierarchy, which is interesting if one considers that incorporation has been included in the context of the new version of the tie-breaker for break entities[1132]; and secondly, that the economic nexus criteria was included only as an alternative to the preferred method, which was the place of effective management. Although the 'economic nexus' test was ignored by the OECD, there are elements of the proposal which are quite relevant from a treaty abuse perspective:

> [OPTION A: 24.2 In some *rare cases* it may be impossible to make a clear determination of the State in which the place of effective management of the entity is situated or the facts may indicate that this place is situated in none of the Contracting States. [...] In these cases subparagraph b) gives preference to the State with which the entity's economic relations are closer. The preference to the State with which the entity's economic relations are closer is based on the conclusion that, in such cases, the entity should be considered a resident of the Contracting State in which it is making greater use of economic resources as well as the legal, financial, physical and social infrastructures. The application of that test will involve examining various factors, such as in which State the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which State the entity derives it (sic) legal status. If an examination of these and other relevant factors taken as a whole clearly shows that the entity is more economically related to one State than to the other, then it will be considered to be a resident of only that State.][1133]

Despite the relevance of all these observations in the current economic framework, and especially under the influence of the BEPS initiative, these proposals have not seen the light of day, and they

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[1129] OECD, *The impact of the communications revolution*, supra note 1117, at pp.11-12.
[1130] Emphasis added. OECD, *The impact of the communications revolution*, supra note 1117, at pp.13-14.
[1131] OECD, *Place of effective management concept: Suggestions for changes to the OECD Model Tax Convention*, (Paris: loose-leaf, 2003).
[1132] Bearing in mind that the new tie-breaker takes into consideration which country's laws govern the legal status of the person, one may conclude that incorporation forms part of new tie-breaker, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.80; and OECD, Action 6: 2015 Final Report, supra note 1, at p.74.
[1133] Emphasis added. OECD, *Place of effective management concept*, supra note 1131, at p.5.

probably never will[1134]. This is highly frustrating, taking into consideration the very interesting work carried out in the context of Action 5 of the BEPS Plan, when seeking to require substantial activities for the applicability of preferential regimes. In the case of intellectual property regimes, for instance, the nexus between the entity and the preferential regime has been observed from different perspectives. Elements such as the place where the expenditures to carry out an activity are in fact incurred, where the research and development takes place, and where the value is created, amongst others[1135], have been considered. Broadly speaking, the initiative has sought to subject the benefits of a preferential regime to the condition "that the taxpayer undertook the core income-generating activities required to produce the type of income covered" in that particular place[1136].

Considering the kind of solution the OECD has designed to deal with BEPS from a tie-breaker point of view, namely to bury the current test and to replace it by the Mutual Agreement Procedure, it is very likely that the proposals by the TAG group will be forgotten. Yet one needs to be very careful when stating that life of the 'place of effective management' test has come to an end. As will be discussed in the following paragraphs, although the OECD has left the impression that the place of effective management will be eliminated from the text of the Model[1137], a careful revision of the proposed Commentaries suggests that the current tie-breaker will not essentially change[1138]. In any case, an entity's economic activities will continue to be ignored for breaking such ties.

12.4.3. The after-BEPS Art.4(3) OECD MC: An updated tie-breaker for entities

12.4.3.1. Replacing the tie-breaker for entities

Although the BEPS Report of 2013 barely touched upon the issue of dual residence, the 2013 Action Plan clearly contemplated the need to neutralise the effects of hybrid mismatch arrangements in dual residence scenarios[1139] and, in general, to re-structure the tie-breaker for entities[1140]. The initiative put forward the need to prevent treaty abuse[1141], and many of the solutions proposed[1142] were at the same time highly relevant in the field of hybrid mismatch arrangements[1143]. Under the new rule, promoted in the context of the BEPS initiative:

> "The following are the changes that are proposed for that purpose:

[1134] According to the 2008 changes to the Commentaries, the failure of the proposal to establish a hierarchy of test was due to the resilience of most member States to abandon the 'place of effective management' test, see OECD, *The 2008 Update to the OECD Model Tax Convention*, (Paris: loose-leaf, 2008); also in van Weeghel, supra note 1097, at p.305. It is interesting to note that to some a hierarchy of tests may be considered "as a more complete answer to the issue", see Confédération Fiscale Européenne, 'Statement on Place of Effective Management Concept', in 43 *European Taxation* 12 (2003), at p.474.

[1135] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report*, (Paris: loose-leaf, October 2015), at pp.24-25.

[1136] OECD, *Explanatory Statement. 2015 Final Reports*, (Paris: loose-leaf, October 2015), at p.14.

[1137] Although it is doubtful whether the States will renegotiate to modify this article in existing treaties.

[1138] In 2009 Plakhin suggested that despite the problems with the place of effective management test, there was little chance of an actual change occurring, see Plakhin, supra note 1115, at p.96.

[1139] See for instance the analysis of the situation through examples in OECD, Action 2: 2015 Final Report, supra note 820, at pp.336-340.

[1140] Problems, according to the OECD, arise "if more than one country seeks to apply such rules to a transaction or structure", see OECD, Action Plan, supra note 27, Action 2, at pp.15-16.

[1141] OECD, Action Plan, supra note 27, Action 6, at p.19.

[1142] OECD, Public Discussion Draft, supra note 27, at p.17.

[1143] OECD, Public Discussion Draft, supra note 510, at p.5.

Replace paragraph 3 of Article 4 of the Model Tax Convention by the following:

> 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States."[1144]

There are two fundamental changes introduced by this new rule to the Model, which represent the essential features of the new test. Firstly, that the dual resident conflict in the case of persons other than individuals will no longer be solved unilaterally, but the States will have to *endeavour to determine*, based on a Mutual Agreement Procedure (MAP), which of those States will be considered as the State of residence[1145]. Secondly, that in the absence of such an agreement the person will not be entitled to any relief or exemption from tax provided by the Model, except where the authorities of both States so agree.

12.4.3.2. Solving the entity residence tie through Mutual Agreement Procedure

12.4.3.2.1. The *elimination* of the place of effective management test

As a consequence of the BEPS initiative, the OECD has proposed the elimination of the 'place of effective management' test, as it exists today. Under the new formula, the contracting Parties are meant to solve the issue through MAP and their agreement must be based on a multiplicity of elements, such as the place of effective management, the place where the entity was incorporated or otherwise constituted, and any other relevant factors.

When explaining how it is that the agreement between the States needs to be reached and the *other relevant factors* to do so, the OECD has explained:

> "Competent authorities having to apply paragraph 3 would be expected to take account of various factors, such as where the meetings of the person's board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc."[1146]

This new version of the entity tie-breaker not only disregards the effectiveness of the economic attachment an entity may have with a certain State from the perspective of its activities, as the TAG Group so eloquently explained. It is also built upon the exact same considerations over which ties of residence in cases of entities are broken today. The 'place of effective management' does not only occupy a predominant role in the line of factors to be considered. When the OECD explains the additional elements to be kept in mind for breaking the tie, almost all those factors relate to, or are intrinsically connected with, the place of effective management as defined according to the Commentaries at different points in time[1147].

[1144] OECD, Action 6: 2014 Deliverable, supra note 902, at p.80; OECD, Action 6: 2015 Final Report, supra note 1, at p.72.

[1145] As Sasseville has noticed, it is relatively clear that this new tie-breaker is not an OECD's invention, but only a recognition of increasingly common practice in the field of treaties, see Sasseville, supra note 1096, at p.296.

[1146] OECD, Action 6: 2014 Deliverable, supra note 902, at p.82.

[1147] It considers the board of directors, for instance, despite the fact that it was added to the Commentaries in 2000 and erased from it in 2008.

Beyond the addition of the place of incorporation test to the criteria of Art.4(3) OECD MC (which does not really represent a significant improvement), the only real *reform* suffered by the tie-breaker for entities lies in the need to consider the potential misuse of the Model as a result of the application of the rule. However, this is something intrinsically connected with the manner in which the OECD MC defines abuse, which according to what has been stated repeatedly across the length of this study, is rather unclear.

If the question were raised as to whether this new tie-breaker changes the methodology through which entity residence ties are broken, the only crucial difference is the exclusion of dual resident companies from the *benefits* of the Model in the absence of an agreement between the parties. There is indeed no obligation to solve the dual residence conflict through MAP under the new rule, and this is a major change. However, while the new test certainly permits a more precise identification of the place where the company has *ties*, it does not appear that the activities of the company, the intensity of the nexus or the reasons giving rise to it, other than the same old reasons to confer residence to entities in the first place (mostly management activities), have been changed in essence. One cannot but observe that the rule will be more complex and the States will be prevented from making unilateral decisions, but this does not imply that substantial changes were proposed in 2015 to the Model.

One needs to assume that the OECD does not really want to replace the place of effective management of entities as a tie-breaker rule[1148] and, because of that, albeit indirectly, the test will continue to operate as the final solution for breaking those ties. The economic activities of the company, which under the TAG Group proposals were taken into consideration to build the link between a company and a State, have been fully ignored, and there is no reason to believe that, according to the new Commentaries, they should even be considered. One cannot but hope that in the context of the MAP the competent authorities will pay attention to this crucial aspect when solving a dual residence conflict, as part of the *other relevant factors* the rule allows them to consider.

12.4.3.2.2. Place of effective management and primary place of management

In close connection with the role of management activities in Art.4(3) OECD MC, it cannot be ignored that other additions have been proposed to the Model in the context of the BEPS project, which suggest that the management of an entity will not cease to be a protagonist for treaty entitlement purposes. The new LOB provision contains a rule according to which publicly traded entities that are not sufficiently connected with the relevant State so as to be defined as 'qualified persons', may nonetheless be considered as such, if they have their 'primary place of management and control' in that State.

The 'primary place of management and control' is defined in the following terms:

> 'd) a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that Contracting State than in any other State and the staff of such persons

[1148] It subsists, in fact, as an alternative test for those States that want to use it. Nothing in relation to the alternative test prepared by the TAG Group was even considered in the field of BEPS, see OECD, Action 6: 2014 Deliverable, supra note 902, at p.82. Sasseville, in 2009, actually observed that after 51 years of analysis in relation to the concept of 'place of effective management', the OECD had gone back exactly to where it began, see Sasseville, supra note 1096, at p.297.

conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other State'[1149]

Despite the fact that the analysis of this concept largely supersedes the boundaries of this study, its similarity with the 'place of effective management' implies that there are some aspects of the term that are worthy of consideration[1150]. For instance, the purpose of this new term, according to the guidelines given by the LOB rule, is to demonstrate the effectiveness of the link between the entity and the State in which treaty benefits are claimed. The purpose of the rule is to consider the management of an entity as evidence of that entity's economic attachment with a State. This cannot but imply that the 'place of effective management' test was not removed from the Model due to its incapacity to measure the level of relevant substance behind an entity, but only because of the many interpretation issues related to its conceptualisation.

That being the case, it is evident that the 2015 changes to Art.4 OECD MC were not necessarily proposed in the light of the guidelines provided by the BEPS initiative because, at the outset, in the OECD's opinion, a test of management is effective enough in demonstrating an entity's level of economic connection with a given State. While this may be the reason why the 'place of effective management' test continues to be so relevant in the context of the new tie-breaker for entities, one cannot but wonder whether the questions posed by the BEPS initiative have been rightly approached when dealing with these aspects of Art.4 OECD MC.

The management test in the LOB provision and the new tie-breaker is considered to be enough to demonstrate the effectiveness of an entity's economic presence, but the economic activities of the entity are fully disregarded. In that context, it is fair to wonder whether the instruments the Model uses to measure the level of 'relevant substance' behind an entity are the more appropriate ones[1151]. The BEPS initiative has precisely raised the question of the appropriateness of the means tax treaties consider to grant its benefits, and yet the fundamental question of whether the existing methods or means to do so are adequate has been ignored. The BEPS project was the perfect excuse to look at these factors from an integral point of view and to discuss their

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1149 OECD, Action 6: 2015 Final Report, supra note 1, at p.50.

1150 By way of illustration, the difficulties in assigning this term its meaning, see van der Weijden, supra note 948, at pp.305-306. The OECD has tried to underpin the differences between these two concepts. In simple terms, it appears that the 'primary place of management' is a more comprehensive version of the 'place of effective management'. According to the OECD, '[t]he term "primary place of management and control" [...] must be distinguished from the concept of "place of effective management", which was used [...] in paragraph 3 of Article 4 and in various provisions, including Article 8, applicable to the operation of ships and aircraft. The concept of "place of effective management" was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business. The concept of the primary place of management and control, by contrast, refers to the place where the day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. A company's primary place of management and control will be situated in the State of residence of that company only if the executive officers and senior management employees exercise day-to- day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in that State than in the other State or any third State, and the staff that support the management in making those decisions are also based in that State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient condition that the headquarters of the company (that is, the place at which the chief executive officer and other top-level executives normally are based) be located in the Contracting State of which the company is a resident', see OECD, Action 6: 2015 Final Report, supra note 1, at p.50.

1151 In 2005 Avery Jones proposed the need of a "more fundamental" look at the issue of entity dual residence, see Avery Jones, supra note 1123, at p.24. This question has been explored from the perspective of the tie-breaker for individuals. Schwartz, for instance, has explored the question of whether those tests are the correct ones, whether there should be a series of tests and, in that case, in what order they should be organised, and whether there are better tests to break residence ties, see Schwartz's comments in Avery Jones et al., supra note 86, at pp.659-664.

pertinence in current times, but only very limited and pragmatic aspects of this discussion have been confronted. Regrettably, a fine opportunity to scrutinise the OECD MC and the policy considerations at the heart of it was lost.

12.4.3.3. The effect of applying the new tie-breaker for entities

The last sentence of the new Art.4(3) OECD MC states:

> In the absence of such agreement [MAP], such person shall not be entitled *to any relief or exemption* from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States."[1152]

Bearing in mind the manner in which this provision has been drafted, the analysis of what the consequences are of applying the treaty tie-breaker is subject to a crucial distinction. On the one hand, there is the possibility of the MAP being successful. In such a case, it is more or less clear that the OECD will try to impose its traditional interpretation of the rule, introduced in 2008, to the effect of excluding the tie-breaker loser from the application of other treaties (with all the difficulties this entails)[1153]. One the other hand, the situation will be different if the States are not able to reach common ground and the MAP is therefore not successful. In that case, according to the new version of the Commentaries:

> "The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the dual-resident person shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities. *This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions* to that person. This will mean, for example, that the condition in subparagraph b) of paragraph 2 of Article 15 will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State. Similarly, if the person is a company, it will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay."[1154]

It is crucial to put emphasis on the limited effect of the absence of agreement between the contracting parties. In such a case, the dual resident entity will not be entitled to *treaty benefits*, that is to say, to relief or exemption (except if the authorities for some reason otherwise agree), but it will nonetheless still be considered as a resident for other treaty purposes. Thus, the residence requirements in rules such as Art.10 or Art.15 OECD MC will still be met, despite the lack of agreement as to the State of residence after the tie-breaker has been applied. The effects of the last sentence of the new version of Art.4(3) OECD MC are therefore circumscribed to the rules of relief or exemption, and not to the rest of the provisions of the treaty, for the purposes of which the residence requirement is relevant.

12.5. Evaluation: Breaking the tie under Art.4(2) and 4(3) OECD MC

Taking into consideration residence from a domestic point of view, the OECD MC breaks the tie between two States by giving preference to one tax claim over the other. The Model's tie-breaker, which in itself does not contain a definition of residence, nevertheless indicates the criteria to be used to break ties, along with the mechanism to apply the tests. When one looks at the policy

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1152 OECD, Action 6: 2014 Deliverable, supra note 902, at p.80; OECD, Action 6: 2015 Final Report, supra note 1, at p.72.

1153 See Sec.8.2 of Comm. to Art.4 OECD Model Convention (2014). The OECD's interpretation of this rule has been largely explored in other parts of this study, see supra at pp.189; Chapter 2, at pp.20ff; Chapter 7, at pp.80ff, and Chapter 10, at pp.156ff.

1154 Emphasis added, see OECD, Action 6: 2015 Final Report, supra note 1, at p.74.

objective behind the creation of the rule, it is fairly clear that the tests need to be defined at the international level. Only in that manner can it be sustained that Art.4(2) and (3) OECD MC contain a definition of residence for treaty purposes that is different from that in the laws of the contracting States.

The OECD has sought to introduce a certain interpretation of the tie-breaker in the Commentaries, according to which a person who loses the tie-breaker needs to be excluded from the scope of any other tax treaties concluded by the State in which the tie is lost. This interpretation, however, contradicts what the OECD has clearly expressed in the same Commentaries regarding the acquisition of the resident status: The Model seeks to impose no standards on domestic residents to be treated as treaty residents. If a person who loses a tie-breaker continues to be treated as a resident under domestic law after the tie has been broken, then it is relatively clear that, under the laws of that State, such person would continue to comply with the conditions imposed by the Model to establish residence. This is precisely the case that the OECD has targeted when promoting this new interpretation of Art.4 OECD MC. In other words, this person, who is a resident domestically (fully liable to tax), should nonetheless be excluded from the application of the Model after losing the tie-breaker. This interpretation is clearly undermined by the provisions of the Commentaries stating that the Model imposes no standards for domestic residents to access tax treaties. Insofar as it creates the impression that any person who overcomes the domestic residence test must be allowed access to the benefits of the Model, the mention of such an interpretation in the Commentaries should be eliminated. The argument that persons who lose the tie-breaker need to be excluded from the application of the Model under Art.4(1) second sentence of the OECD MC is not conclusive, precisely because of the manner in which the OECD has described the issue.

It cannot be forgotten that at some point during the history of the Model it was proposed that the definition of residence was to have an effect for the purposes of *this* Convention *and the internal laws* of the contracting States. Such proposal did nonetheless not progress. This idea underpins a fundamental aspect of the definition of residence, which is the relevance of defining very precisely the case to which the new interpretation of the tie-breaker applies, to avoid confusion. As was mentioned in the previous paragraph, if a person loses a tie-breaker, the person will not automatically be subject to limited tax liability (i.e. treated as a non-resident). This would only occur if the laws of the State in which the tie has been lost treat that person as a non-resident therefrom (as in the case of Canada and the UK). In such a case, the tie-breaker loser will not be considered to be a resident for the purposes of other treaties. This, however, will occur as a consequence of the application of the first sentence of Art.4 OECD MC (limited tax liability), and not of the second sentence (unlimited tax liability limited to certain income).

It may be sustained that the modifications introduced to the Commentaries in 2008 may have been motivated by the need to counter treaty abuse. However, as has been explained in other parts of this study, the inclusion of a second sentence to Art.4(1) OECD MC had nothing to do with abuse in the first place. Further, when one analyses the precise criteria used in the tie-breaker for individuals and entities from that particular perspective, it does not seem that the terms used in it have the purpose of adding relevant substance to the Model. On the contrary, the history of the Model demonstrates that the economic activities of the person had only a secondary role when determining which of the contracting States would win the tie. From a policy perspective, it is hard to imagine how it is that such a test may be destined to counter tax treaty abuse.

Assuming the need to address the issue of treaty abuse through a certain interpretation of the tie-breaker, it is curious, to say the least, that nowadays, in the context of BEPS, the OECD has turned a blind eye to the tie-breaker for individuals. Keeping in mind the definitions contained in the

BEPS Report, it is hardly deniable that artists, sportsmen, and other individuals are in fact able to segregate income from their sources. They are able to design dual residence schemes to abuse tax treaties, as the criteria used in the Model to break ties pays little attention to the effectiveness of the economic nexus between the individual and the relevant State. There is in fact case law on the matter, and the tax authorities of some States have had to fight these strategies by playing on and beyond the boundaries of the Model, and focusing, primarily, on their domestic tax rules. This is perhaps the reason why it is so outrageous that not a single word has been dedicated to the tie-breaker for individuals in the context of BEPS.

In the case of entities, on the other hand, a distinction must be made between the entity tie-breaker before and after the BEPS initiative. The BEPS project questioned the lack of economic attachment between the treaty claimant and the relevant State. The obvious question this raises is how to measure such an attachment. The work of the TAG Group has left it clear that the economic activities of a company may be quite illustrative of the place with which a company has a strong nexus from an economic point of view. Yet the OECD has ignored this, and seems to have preferred the place of effective management test, despite its regrettable origin, and the many interpretative issues it has generated over the years.

Under the new version of Art.4(3) OECD MC, proposed in 2015, it is the tax authorities of the States which will endeavour to solve the issue on the basis of the place of incorporation, place of management, and several other factors. If the tie is successfully broken, then the OECD's interpretation as to the effect of the tie-breaker needs to be applied to the tie-breaker loser. If, on the contrary, the authorities of both States do not reach an agreement, the dual resident taxpayer will not have access to any *relief or exemption* contained in the Model. This implies that the absence of agreement is not meant to deprive the treaty claimant of its characterisation as a treaty resident for other relevant treaty purposes, such as those derived from the application of Art.10 or Art.15 OECD MC, amongst other rules.

Bearing in mind the drafting of the new version of Art.4(3) OECD MC, one may easily conclude that there will be little consideration, if any, to the economic activities carried out by the entity when breaking the tie. Everything indicates that the place of effective management test will continue to play quite a preponderant role when doing so. The proposals by the TAG Group, which contained very detailed instructions of how to elaborate a test based on an effective economic nexus, were fully ignored for these purposes.

This, however, should not be surprising, for the OECD decided at a certain point in time that economic considerations were more appropriate for the purposes of source taxation rather than to the construction of residence. An explicit decision was made to use the personal dimension of the relevant taxpayer to break ties, instead of his effective economic attachment to a certain jurisdiction. While this explains the many difficulties in trying to attribute a meaning to residence that is significant from an economic point of view, the rise of treaty abuse as an international concern has changed the manner in which one needs to look at the Model. The question of profit shifting, for instance, is a question that aims at the heart of the OECD MC, namely the policy reasons which make its use *inappropriate.* The unsatisfactory results derived from the use of the Model are mainly connected with its inefficiency in protecting the balance between residence and source, and the tie-breaker is not an exception to these flaws. All these problems, however, are derived from a very precise cause, which is the lack of a satisfactory determination of the place with which the treaty claimant has an effective economic nexus on the basis of its rules, which is, again, a rather general concern.

If one looks at the issue from the perspective of the proposed additions to the Model, it may be the case that the new GAAR is employed to try to counter these strategies. Yet, as has been stated before, the scope of the rule is rather restricted and does not affect the characterisation of a person as a resident of a contracting State, at least not in a permanent manner. The same applies to the LOB rule, in respect of which it is evident that no barrier is put for individuals, for instance, to use the Model to shift profits. In the case of entities, the 'place of effective management' and thus the possibility of tax planning on the basis of it formally disappears. However, it cannot be ignored that the new guidelines pay little attention to the activities of the entity for breaking ties while perpetuating, at the same time, the management of such entities as a relevant factor to settle the issue.

One needs to understand that a permanent home can be purposely set up, that the place where a board of directors meet can be changed to a tax efficient location, but that an entity or individual will not be simply shifting its activities from one State to another with the view of optimising its tax burdens, in an opportunistic manner. All of this raises the question of whether the focus in current times, when conceptualising the test of residence and the tie-breakers, is the correct one. Perhaps rather than focusing on the tests themselves it is time to look at the Model as a whole and the manner in which these concepts materialise in a reasonable balance between residence and source. Sadly, in the context of the BEPS initiative, the opportunity to do so has not been taken.

The dual residence tests disregard, in general, the economic dimension of the relevant taxpayer. Under the Model and even under the new proposed rules residence ties are broken in the absence of an effective economic nexus. Considering all these apprehensions, it would not be strange if the tendency to ignore the rules contained in Art.4(2) and (3) OECD MC, and to replace them with a generic rule denying treaty entitlement in cases of dual residence, evolves into a common practice.

PART V

CONCLUSIONS AND RECOMMENDATIONS

13. Chapter 13 Conclusions and recommendations

13.1. Conclusions

13.1.1. General considerations

Most of the difficulties related to the interpretation of tax treaties derive from the lack of clarity as to the meaning of the term 'resident of a contracting State'. In simple terms, when the question of whether the benefits of a treaty may be availed of is raised, the drafting of the provision and the expressions used in it are misleading. While the term should provide a solid basis for any decision on tax treaty entitlement, its many shades of meaning create several obstacles for a coherent interpretation of the Model. In some cases, though the treaty entitlement seems adequate from a policy perspective, the definition of residence seems to be too narrow and certain persons are nonetheless excluded from the application of the Model. More often than not, however, the definition seems to be too broad, as tax treaties are commonly applied in circumstances that appear to be inappropriate from the standpoint of policy considerations. Under the description of the term 'resident' in the OECD MC, in occasions too broad and at times too narrow, a coherent interpretation of the OECD MC presents quite a significant challenge.

13.1.2. Issues connected to the definition of residence in Art.4 OECD MC as a legal term, including the attribution of its ordinary meaning to the term 'liable to tax'

a) Chapter 2: Does the OECD MC define the term 'resident of a contracting State'?

The fact that the Model *defines* residence may appear to be too obvious, and yet there are those who sustain that Art.4 OECD MC is only meant to set out a redirection to the laws of the States dealing with residence. Under such reasoning there would be little point in arguing that cases of treaty shopping, for instance, should be excluded from the scope of the Model through the definition of residence. After all, if Art.4 OECD MC is merely meant to redirect to the laws of the States dealing with residence, and under those laws a conduit company were a resident, then such a treaty claimant would automatically obtain access to the provisions and benefits of the Model. According to the conclusions arrived at in Chapter 2, this does not appear to be the logic behind Art.4 OECD MC.

The idea that the definition of residence contains a simple redirection to the laws of the States has an historic explanation. Historically, Art.4 OECD MC was built on the premise that residence was a domestic issue. Based on this reasoning, there was no need to define residence at the treaty level, let alone to create standards to be fulfilled by domestic residents to reach the scope of the treaty. Under the original definition, as Vogel gracefully explained, if there was only one domestic residence, that was also the relevant treaty residence. The description of the term 'resident' contained in the primitive versions of the Model, although very similar to the current one, was only meant to set out a *preference* criterion. That is to say, the rule was meant to break residence ties and not to introduce a concept of general application.

At a given point in time, as the history of the Model so neatly demonstrates, the OECD decided to abandon this position and to use the term 'resident' to provide certain guarantees in relation to the application of tax treaties. The Commentaries were modified to state that Art.4 OECD MC was meant to *define* residence for all treaty purposes, and not only for the purposes of the tie-breaker. Throughout the following decades, additions were made to the Commentaries to explain the case of certain treaty claimants that had to be excluded from its scope. Under this approach, persons such as conduit companies and residents of a State having lost a tie-breaker, for instance, could not be considered to be residents for tax treaty purposes. The issue of tax treaty abuse is clearly one of those crucial aspects of the application of tax treaties the OECD has tried to confront by attributing a certain meaning to the term 'resident'. Whether the OECD has been successful or not in doing so, and whether this was the right path to follow when confronting these concerns in the first place, those are quite different questions.

On the surface, it is rather evident that the words of Art.4 OECD MC are not only meant to define the term 'resident' at the treaty level, but they are also meant to impose certain standards to define the applicability of the Model on the basis of that meaning. This is particularly relevant if one pays attention to the term 'liable to tax' because, under Art.4 OECD MC, residence *means* 'liable to tax'. It is the meaning of tax liability that determines the ability of certain treaty claimants (transparent entities, bodies of persons and contractual arrangements; pension funds, charities, educational institutions, and tax-exempt persons in general; conduit companies and residents of States having lost a tie-breaker; and even residents of States applying the territorial principle of taxation), to access the Model on the basis of its interpretation. Through the attribution of a certain meaning to this undefined treaty term the OECD has ultimately answered the question as to the meaning of residence, and what are the precise conditions domestic residents need to fulfil to access tax treaties. Therefore, to state that the purpose behind Art.4 OECD MC is to set up a mere redirection to the domestic laws of the States dealing with residence would not be entirely accurate. The OECD MC *defines* treaty residence. It is the meaning of the term 'liable to tax', attributed to the term by interpreting the many additions to the Model and the Commentaries made by the OECD throughout the years, that governs the application of tax treaties. There lies the relevance of trying to find its meaning.

b) Chapter 3: What is the source for a definition of the term 'liable to tax'? Does the term 'liable to tax', as an undefined treaty term, need to be defined under Art.3(2) OECD MC?

Having stated the need to attribute its meaning to the term 'liable to tax' in order to decide whether or not a tax treaty needs to be applied, Chapter 3 attempted to find the source from where the concept must be defined. This may be relevant because the States often disagree as to the tax liability of certain persons, and this disagreement often occurs because a person who is 'liable to tax' under the laws of one State may not be considered to be 'liable to tax' under the laws of its counterparty. In the case of a contractual arrangement, one of the States may actually see an entity, therefore acknowledging its tax liability, whereas its counterparty may only see a group of persons, not a separate entity, thus denying treaty benefits at that level. Yet this is a rather general concern, insofar as the same logic also applies to tax-exempt persons or in cases of alleged abuse, situations in which some States may be reluctant to recognise the existence of a tax liability under their own laws.

When attempting to attribute its meaning to the term 'liable to tax' as an undefined treaty term, one may be inclined to believe that the general rule of Art.3(2) OECD MC is meant to solve the problem. According to this rule, undefined treaty terms must be attributed their meaning under the laws of the State *applying the treaty*, except where the context otherwise requires. Bearing in mind that both States apply the treaty, each in its own manner, a diverging opinion as to the tax liability of an entity could hamper the interpretation of its provisions. The rule of Art.4 OECD MC, however, contains a very clear reference to the laws of only one of the States applying the treaty, the State of residence, and therefore the rule sets out a crucial exception to the reasoning behind

Art.3(2) OECD MC. Under this exception, the attribution of its ordinary meaning to the term 'liable to tax' must be carried out exclusively under the laws of the State of residence, and not under the laws of the State *applying the treaty*. The laws of the State of source are irrelevant, and so are the rules of the treaty, if they are applied in a manner unconnected to the rules of the State of residence.

In the *Crown Forest* case, for instance, both the lower Court and the Court of Appeal made the mistake of trying to assess the situation of the treaty claimant (Norsk) solely on the basis of the rules of the treaty. They both concluded that the relevant entity's tax liability in the United States was based on having a place of business therein, as the place of business was mentioned amongst the criteria of residence in the treaty. Both courts missed the fact that Norsk was treated as a non-resident under the laws of the United States. Luckily, the Supreme Court of Canada amended this, as there cannot be residence at the level of a tax treaty if there is no tax liability *under the laws of the State of residence*. Domestic residence, in other words, is a condition for treaty residence, and this condition is given by the meaning of the term 'liable to tax', which must be ascertained only from the perspective of one of the contracting States.

Needless to say, if the laws of the State of residence, or any other legal instrument defined as appropriate under each State's constitutional order, do not define the term 'liable to tax' (as it is often the case), then the term will have to be attributed its meaning at the treaty level. If that were the case, the many elements provided by the OECD to describe the expression in the Model will have to be analysed in the light of the general rule of interpretation of public international law. Only after having done so would it be possible to decide if, under the laws of the State of residence, the conditions imposed by the meaning attributed to the expression are met by any given treaty claimant.

c) Chapter 4: What sort of persons may be considered to be 'liable to tax'? May bodies of persons or transparent entities be included within the subjective scope of the Model? Is the situation of the income treaty claimants receive relevant when ascertaining their tax liability?

When facing the challenge of finding the meaning of the term 'liable to tax', the first aspect of the definition that is of importance is the reference implied in the term. As explained in Chapter 4, tax liability, in the context of Art.4 OECD MC, is an attribute of persons. One must be very careful when looking at the definition of residence from this perspective. Although the term 'person' has been defined in a very broad manner in Art.3 OECD MC to provide a wide scope of application to the Model (capable of even including partnerships, transparent entities and contractual arrangements within its scope), the term 'liable to tax' is not necessarily without limits.

Under the description of the term 'liable to tax' made by the OECD there must be a *corpus* on which the tax authority of a State may be extended. While grasping this idea is relatively simple in the case of individuals, it is much more complex in the case of entities. The history of the Model clearly suggests, however, that even though the legal form chosen is immaterial, and despite the fact that the actual incorporation of an entity is not required, a separate existence is needed for treaty benefits to be granted. The Commentaries further clarify that in addition to a *separate unit*, the relevant treaty claimant must also be identifiable as a *taxable unit*, on which the authority of a State may at least eventually be applied. The Model, after all, refers to a *body* of persons, identifiable in itself, and not to a *group* of persons.

Following this logic, a fully transparent entity or a mere contractual arrangement will rarely be *submitted to the tax authority* of a State (which is the condition imposed by the ordinary meaning of the term 'liable to tax'), because it will not be considered to be a *taxpayer* from a domestic law perspective. Such an entity would therefore not be a resident under Art.4 OECD MC, but its partners may be if they meet the requirements imposed by the rule. According to the Commentaries, the meaning of the term 'liable to tax' in cases of partnerships requires the entity to be *treated as a company*, that is to say, as a separate taxable unit, or at least to be *taxed in the same way*. The latter case requires the recognition of a separate taxable unit, diverse from its partners, that may be subject to the tax authority of a State, as this is the way in which companies are taxed.

According to the standards imposed by the Model, although it would not be harmful to consider a transparent entity or a contractual arrangement as a 'person' under Art.3 OECD MC (although even this idea is very much debatable), such an entity cannot be considered to be 'liable to tax'. Despite the fact that the Model deals not only with current but also with potential double taxation, the potential tax liability of a transparent entity, that is to say, the potential fact that a State may decide to modify its laws to actually submit such an alleged *entity* to its tax authority, is far too potential to be grounded on a reasonable interpretation of the Model. The definition of the term 'person' in the OECD MC may be without limits, but this does not mean that the term 'resident' may be equivalently comprehensive.

Lastly, and in close connection to the above-mentioned ideas, bearing in mind that tax liability has been described as an attribute of persons, one should not, under the rules of the Model, be concerned with the situation of the income these persons receive. This aspect of the definition of residence was underpinned by the Delegation for Belgium already in 1967 and, after that, Couzin, and above all Wheeler, have largely explained the consequences of this configuration. Diverse rulings have attempted to secure the granting of treaty benefits in cases of transparency when the relevant *income* is effectively subject to tax in the hands of a person who is a resident, even if that person is not the entity itself, but its partners. By focusing on the income received and its taxation, this interpretation stretches the rules of the Model beyond a reasonable point. Although desirable in terms of policy, these rulings cannot be said to be based solely on the provisions of Art.4 OECD MC, for the Model's tax liability is focused on the situation of the treaty claimant, the *person*, and not on the income for which treaty benefits are claimed. As Wheeler so gracefully observed, the possibility to sustain such an interpretation of the Model would require the rule of residence to be drafted in a sensibly different manner: A person would not only have to be 'liable to tax', but it would have to be 'liable to tax on the income' for the purposes of which treaty protection is claimed.

d) Chapter 5: By reason of which factors must tax liability arise at the domestic level to cause tax liability to arise under the rules of the Model? Do the examples used in Art.4(1) OECD MC restrict the ability of other factors to generate treaty residence?

In addition to the fact that this attribute called tax liability must arise under the laws of the State of residence, according to the rules of the Model it must also arise *by reason of* these laws, and as an effect of the presence of a given connecting factor. This element of the definition of residence, explored in detail in Chapter 5, is not immaterial, but it denotes a situation of causality: Under Art.4 OECD MC, a person's tax liability must arise *as a consequence of* that person being submitted to the tax authority of a State.

To some, like Vogel, the particular words used in Art.4 OECD MC would insinuate that the connection of authority implied in the term 'liable to tax' needs to be qualified in a certain way, that is, of a certain *intensity*, for a person to access the Model. In other words, given the connecting criteria mentioned in the rule (domicile, residence, place of management), Vogel concluded that a *locality-related* attachment was necessary for tax liability to arise, and therefore formal criteria such as incorporation, in the case of entities, or nationality, did not appear to meet the minimum test. According to Vogel's reasoning, only certain domestic tax liabilities would be apt to generate residence at the treaty level.

The history of the Model does not seem to support Vogel's theory. The connecting factors in Art.4 OECD MC were chosen not with the intention of setting out a meaning of 'liable to tax' that was different than the meaning of residence at the domestic level. These criteria did not refer to a locality-related attachment, or to any kind of attachment other than those defined by the laws of the different States as relevant in order to extend their tax authority over certain persons (even if criteria as shallow as incorporation or nationality were used by those States). The history of Art.4 OECD MC suggests that the OECD's sole intention was to stress the fact that the allegiance required by the use of the term 'liable to tax' was strictly personal, and not solely based on the source of the relevant income. In some primitive drafts of the definition of residence, the list of connecting factors was followed by the word *etc.*, to clarify that any other factor was capable of generating treaty residence, as long as it was based on the personal characteristics of the treaty claimant. Further, the reference to 'source' in certain drafts as part of the list of connecting criteria seems to indicate that the elements mentioned in the rule were not meant to refer exclusively to worldwide taxation either.

Bearing this in mind, and considering the need not to exclude residents from States applying the territorial system of taxation from the scope of the Model, the only possible way of reading the Commentaries so as to not to produce an inconsistent result is to understand that residents of these States do have a personal allegiance with their so-called State of *residence*. As has been stated in relation to French companies, the fact that their tax base is limited to income arising from sources in that particular State should not be taken to imply that they are not liable to tax therein.

The purpose behind the three connecting factors mentioned in Art.4 OECD MC, domicile, residence, and place of management, selected by the OECD due to their popularity, was only to underline the need of an attachment based on personal attributes, and not on the basis of solely having income arising from sources in a given State. It is on this basis that other elements, not expressly mentioned in the rule, may nevertheless be included within the scope of the Model if they are of a *similar nature*. Under Art.4 OECD MC, similarity in nature depends on the ability of the relevant factor to trigger a domestic tax liability based on personal attributes, because tax liability is an attribute of persons. Therefore, incorporation or nationality should not be left outside the scope of the Model, if they do play that role at the level of domestic law, without severe reservations.

e) Chapter 6: How does the OECD MC define the relation of authority described by the use of the term 'liable to tax'? Does the definition of residence impose any conditions so as to define the circumstances, moment, or extent to which the tax authority of a State must be extended over the treaty claimant for treaty residence to arise?

It is relatively clear that the term 'liable to tax', as used in the first sentence of Art.4(1) OECD MC, refers to a connection of authority between a person and a State that is based on personal attributes. Yet the OECD has gone much further to describe the particular character of this relation when explaining the manner in which this tax authority needs to be conceived from the perspective of the relevant State, and thus the circumstances in which the Model needs to be applied. All these aspects were studied in detail in Chapter 6.

Taking into consideration these explanations, one may conclude that tax liability refers to a relation of authority that is general, that is to say, related to all the circumstances of a person, and not limited to certain spheres of its life or to specific acts carried out by it. The term 'liable to tax' refers to an authority that is in principle unrestricted, as it applies to all the acts of a person, finding a limit only where the authority of another State is to be applied over the same person. In such a case, the Model solves the conflict by giving preference to one claim over the other.

The fact that tax liability is general, however, should not be taken to imply that the term 'liable to tax' *means* worldwide taxation, because persons who are residents of States applying the territorial principle of taxation cannot be left outside the scope of the Model. This interpretation of the term is consistent with the position of States like France. The system of territoriality, under the OECD MC, should only be seen as a system that restricts the relevant tax base, but where the person maintains an allegiance based on the extension of the authority of the relevant State. Such an understanding of the rule implies that companies are liable to tax in France *by reason of* their allegiance to France, under its laws, and not simply because of their income arising therein.

Secondly, tax liability is a permanent attribute. This basically implies that tax liability is not limited in time (except, of course, where the laws of a State determine its end). Thirdly, tax liability under Art.4 OECD MC is abstract, because it exists, in principle, regardless of the material exercise of that authority over the person. In other words, the authority of a State cannot be considered to be relinquished if it is not exercised. Irrespective of the question of whether effective taxation is needed for tax liability to arise under the rules of the Model, which is a different question, the authority portrayed by the term needs to be at least latent (this is the minimum standard imposed by the rule), and the treaty claimant must be subject to the possibility of being submitted to this authority at any time. Moreover, tax liability does not refer to any taxes in particular, but only to a submission to a State's tax authority that is, as has been stated several times before, only based on personal attributes. According to the title of the Model, it is enough if these taxes are taxes *on income and capital.* The precise nature of the taxes a person is liable for in a given State is irrelevant in this regard.

Last but not least, the tax liability described by the OECD in its Model Convention is one that arises under very particular temporal rules. If the treaty claimant is a resident in more than one State during the same taxable year, but during different specific periods (as in the Smallwood case), then the Commentaries indicate that one should be able to determine which particular State the person was a resident of when the specific *income* tax liability causing the application of the Model was triggered. In other words, if a person was a resident of State A during the first part of a given year, and then shifted its residence to State B, then, for the purposes of applying the A-B treaty, the person would need not to be considered a resident of A or B for the entire taxable period (usually a year). On the contrary, this person will only have to be considered as such during the specific period in which residence was established in each State. Therefore, by this logic, if income for which treaty benefits are claimed were received by this person during the first part of the taxable year, even if the laws of State B would consider that person to be a resident in State B for the entire taxable period (and thus liable to tax on that income in State B), under the rules of the Model State B would have to refrain from treating such person as a resident. This would avoid, amongst other things, the rise of an artificial dual residence conflict where the person, despite not having resided in two States at the exact same time is, as in the Smallwood case, treated as a dual resident.

Bearing in mind the manner in which the definition of residence has been structured, and the fact that it focuses on the person and not on the income for which treaty protection is claimed, this interpretation is quite difficult to sustain. Yet the temporal element of the definition is a crucial standard the OECD has sought to impose to distinguish domestic residents from treaty residents when trying to ascertain whether the Model needs to be applied or not.

f) Chapter 7: What is the meaning of 'comprehensive' tax liability? Does the second sentence of Art.4(1) OECD MC set out the meaning of tax liability for tax treaty purposes?

The question of whether further requirements are imposed on domestic residents to reach the scope of the Model is particularly relevant when one confronts the analysis of the second sentence of Art.4(1) OECD MC, and the question of whether the adjective 'comprehensive' sets out the meaning of the term 'liable to tax' for treaty purposes, analysed in Chapter 7. The OECD has promoted an interpretation of the rule in 1992 and 2008 so as to exclude certain residents from the application of the Model, under the guise of these persons not being subject to 'comprehensive' tax liability. Despite how noble the attempt to counter treaty abuse may be, the history of the OECD MC neatly demonstrates that the introduction of the rule to which this interpretation has been ascribed had nothing to do with treaty abuse in the first place. On the contrary, the second sentence of Art.4(1) OECD MC was added to the Model in 1976 to make sure that the application of its rules would not interfere with certain privileges (tax benefits) granted to diplomats under international law. In order to secure those benefits, the mechanism designed was not to consider the diplomat as a resident in the receiving State for treaty purposes. While this may have been achieved, according to the OECD, by means of a tie-breaker solving the dual residence conflict in favour of the State sending the diplomat (indeed a questionable solution), the likelihood of the sending State not raising any claims based on residence taxation over diplomats sent to another State (and thus the impossibility of breaking the tie in its favour) made the addition of this sentence necessary.

The second sentence of Art.4(1) OECD MC could not have been meant to deal with abuse unless one understands that diplomats establish residence in the receiving State with the sole or predominant intention to obtain tax treaty benefits. The issue of abuse in the case of conduit companies and dual residents was examined as early as in 1962 and 1964, by no less than the same working group within the OECD in charge of the situation of diplomats, and these concerns were nevertheless never mixed up. There are no records of a connection between these topics being even noticed by anyone at the OECD, because those in charge of the debate were well aware of the lack of identity between these issues. The case of diplomats was not a case of treaty abuse, and thus the addition of a second sentence to Art.4(1) OECD MC could not have been driven by the need to prevent the occurrence of abuse. It is thus surprising that, approximately 30 years after the debate was raised in the case of conduit companies, and 44 years later in the case of dual residents, the OECD decided to stretch the interpretation of the rule by arguing that there was a certain *spirit* behind it. The interpretation promoted by the OECD so as to exclude these persons from the scope of the definition of residence was in fact totally outside the scope of the original provision.

Adjectives such as 'full', 'comprehensive' and 'unlimited', on the other hand, were not meant to set out a meaning that was different to that of the expression 'liable to tax', as used in the first sentence of Art.4(1) OECD MC. These expressions were employed to refer to the term 'liable to tax' from the beginning of the discussion on residence, early in the decade of the 1950's, long before the addition of a second sentence to Art.4(1) OECD MC. These terms are neither newer than nor contemporary to the rule, and they were not meant to suggest that a particular tax base or tax rate were needed for a person to be considered to be a resident for treaty purposes. On the contrary, these terms were of relevance only because they were indistinctively used to stress the fact that the connection of authority, as defined by the term 'liable to tax', was based on personal attributes instead of on income arising from sources in a given State (in which case the term ‘limited tax liability’ was used). Trying to assign a different meaning to these terms generates a series of interpretative difficulties.

The problems of interpretation derived from the use of these terms have in fact risen only because the OECD has attempted to deprive them of their original meaning by describing the tax liability of a conduit company as not ‘comprehensive’, if all its foreign income is tax-exempt. Arguably, even if one agrees with the OECD in relation to the need to interpret the Commentaries *dynamically*, this cannot imply that a simple addition to the Commentaries may have the authority to modify the meaning of a tax treaty term, as it occurred in 1992 and 2008.

Further, this interpretation of the rule creates the need to clarify that residents of States applying the territorial principle are not excluded from the scope of the Model, because from a tax base perspective, there are little practical differences between a conduit company and a resident of one of these States. Yet if one reads this rule restrictively, as the OECD has instructed, and according to its alleged purpose, which is to oppose abusive tax treaty entitlement, this clarification would not even be needed.

Under a strict interpretation of the second sentence of Art.4(1) OECD MC, one needs to understand that certain situations, which may be classified as *abusive*, need to be excluded from the application of the Model, whereas the rest of them must not. In simple terms, diplomats, residents of territorial States, residents of States applying capital-import neutrality, amongst others, cannot be excluded from the scope of the Model even if their foreign income were tax-exempt, because the exemption they enjoy does not derive from a tax avoidance strategy. While this would be the only possible way of reading Art.4 OECD MC according to the instructions given by the OECD in a reasonable manner, this interpretation implies that if a claim were raised that a conduit company or a dual resident needs to be excluded from the scope of the Model, then the avoidance motivation of the respective person must be demonstrated first.

Despite the much broader question of whether the definition of residence has the appropriate means to deal with the issue of abuse, explained extensively in later paragraphs of these conclusions, although the Commentaries attempt to characterise the situation of conduit companies and dual residents as intrinsically abusive, it is precisely that understanding of Art.4 OECD MC which makes it impossible to achieve a coherent interpretation of its rules.

g) Chapter 8: Does the authority of a State need to be exercised for tax liability to arise under Art.4 OECD MC? Is effective taxation required for the benefits of the Model to be granted under the definition of residence?

On the face of it, the definition of residence is often too narrow. Although the tax treaty entitlement of tax-exempt pension funds, charities, or educational institutions seems to be reasonable from a policy point of view, these entities are often refused access to the benefits of the Model under the pretext of not being ‘liable to tax’.

However, according to the conclusions arrived at in Chapter 8, the exercise of the tax authority of a given State over the treaty claimant, that is, *effective taxation*, is in no way a condition for the purposes of applying the OECD MC. On the contrary, the policy embedded by the OECD in its Model is sound and clear: The benefits of the Model in the State of source are not subject to the condition of taxation in the State of residence, and *vice versa*. The Model, at the outset, attributes a higher value to the sovereign right of the States not to tax, than to the need to apply the Model in scenarios of effective double taxation only.

The meaning of the words 'may be taxed' in Art.23 OECD MC is coherent with this policy, and so is the *absolute obligation* to provide an exemption, contained in the Commentaries. There is only one exception to this rule, which focuses on conflicts of characterisation, but that is not able to form a general principle of treaty interpretation. The credit system, on the other hand, impedes the occurrence of non-taxation, but that is just an effect of how the credit mechanism operates. As a matter of fact, when reading the history of the Model, it is interesting to note that tax-sparing clauses were proposed to be included in the Model because their presence was thought to be *convenient*. The OECD's change of heart in relation to these rules, which occurred only in 2000 anyway, does not alter the fact that non-taxation forms part of what the OECD has defined as appropriate, from a policy point of view, for the application of its Model.

It is therefore in the context of a Model in which the States may legitimately decide not to exercise their tax authority over the treaty claimant that the term 'liable to tax' must be attributed its ordinary meaning. Allegedly, this provides several reasons to support the idea that tax-exempt pension funds, charities, and other similar institutions are 'liable to tax' in the sphere of Art.4 OECD MC, but it is also relevant if an attempt is made to describe what the object and purpose behind an agreement such as the OECD MC is, from the perspective of its text.

h) Chapter 9: How do the elements provided by the Model contribute to the attribution of its ordinary meaning to the term 'liable to tax' under the VCLT, and to the identification of the Model's object and purpose?

The quest for the ordinary meaning of 'liable to tax' in good faith under the VCLT is commonly addressed from the perspective of the alleged object and purpose of tax treaties. To some, this purpose is restricted to the avoidance of double taxation, and therefore they understand that 'liable to tax' means 'taxed'. To others, tax treaties have a much broader purpose, which is only to allocate tax jurisdiction, and thus they conclude that the meaning of 'liable to tax' cannot require effective taxation for the Model to operate. This conflict is fairly relevant if one considers the tax treaty entitlement of pension funds and other tax-exempt entities. Under the general rule of interpretation of public international law, this manner of confronting the issue is wrong. One cannot simply assume that there is a certain object and purpose of tax treaties which drives the attribution of its meaning to the term 'liable to tax'. On the contrary, several aspects of the definition need to be considered first.

The question as to the attribution of its meaning to the term 'liable to tax' under the VCLT, explored in Chapter 9 of the present study, presupposes a very complicated process. A fair, honest and reasonable interpretation of the term, in good faith, must be able to harmonise and reconcile all the different and even diverging elements used throughout the OECD MC to describe the expression. By way of illustration, one should be capable of attributing its meaning to the term 'liable to tax' in a way in which conduit companies are excluded from its application, without leaving residents of States applying the territorial principle outside its scope. It should also be possible to assign its meaning to the expression by keeping in mind that some States require effective taxation as a condition for treaty benefits while others do not. Further, while under the principle of effectiveness such an interpretation must tend to give effect to the intention of the parties, clearly expressed in the text of their agreement (in this case, a model treaty), this does not imply that the expressions used in it must be attributed a meaning capable of causing an effect at any cost. For instance, the expression 'liable to tax' should not be attributed a meaning equivalent to 'taxed' because the treaty needs to cause an effect (in this case, to avoid effective double taxation). All the interpretation of the term 'liable to tax' in good faith requires is the attribution of its ordinary meaning to the expression in its context, and in the light of the Model's object and purpose. These are the boundaries, according to the VCLT, the trespassing of which would constitute a breach of good faith, and also an abuse of rights. It is crucial to stress the fact that, under the VCLT, none of these principles is more important than the others. They all have the same importance and they must be applied jointly, using an *integration approach*.

When delving into the policy objectives pursued by the OECD in order to attribute its meaning to the term 'liable to tax', therefore unlocking the door which grants access to treaty benefits, the first element that poses a significant challenge is the context in which the expression is used. The definition of residence forms part of a much more extended set of rules, elaborated by the OECD with the view of drafting a prototypical agreement, to be used by a variety of States. While the Model itself says little in relation to the term 'liable to tax', the fundamental elements describing the expression are actually contained in the Commentaries.

Beyond the debate as to whether the Commentaries are legally binding or not, they do play a fundamental role in interpreting tax treaties. Just as the Protocol of a treaty allows the interpreter to grasp the policy expectations the parties pursue in the case of a particular tax treaty, the Commentaries to the OECD MC contain a synthesis of the policy considerations that make the use of the Model desirable from the perspective of the OECD. This is why, for instance, the Commentaries declare that in some States taxation is required for the purposes of defining tax liability, while in others it is not. Although this seems to be contradictory, the Commentaries could not have been drafted in a different way. Their purpose is, on the one hand, to explain the meaning of the terms used in the Model and, on the other hand, to make sure that no State is actually precluded from using its provisions. The widespread adoption of the Model depends on that, no matter the diverse nature of the policy objectives pursued by different States. If one observes the Model from this perspective, the apparent inconsistencies in the Commentaries do not really represent essential contradictions, but only the need to establish a broad spectrum of policy considerations that may justify the use of the Model by any State.

Some States promote capital-export neutrality while at the same time other States decide to implement capital-import neutrality, and both types of States are nonetheless allowed and even encouraged to do so on the basis of the same model convention. When attributing its meaning to the term 'liable to tax' under the VCLT, the only certainty as to the manner in which this must be done seems to be that its meaning cannot preclude the use of the Model in any of these cases.

Because the use of the Model needs to be sustained in States applying the capital-import neutrality principle, the OECD acknowledges and accepts the fact that effective taxation cannot be imposed as a condition for tax treaty entitlement. If this were not the case, no State would find any interest in entering into a tax treaty based on the Model with a country like the Netherlands, for instance, where that principle is followed. The sovereign right *not to tax* is therefore a fundamental piece of the treaty bargain, and one should not readily assume that the policy behind the Model imposes the need to renounce to that prerogative, or at least not without severely threatening the adoption of the Model. The policy objectives embedded by the OECD in its Model, and materialised through the use of the expression 'liable to tax' in a certain context are therefore not *accidentally* confusing.

Similar considerations apply when approaching the Model's object and purpose from the perspective of the definition of residence. If a treaty were concluded with a State applying the capital-import neutrality principle, one could reasonably assume that this circumstance was known to its counterparty during the negotiation process. If, in that context, the State of residence does not tax the treaty claimant, and on the basis of this the State of source denies the benefits of the treaty, one could reasonably wonder whether the State of source has interpreted the treaty in good faith. The lack of taxation in the State of residence should bear no consequences for the purposes of the State of source fulfilling its obligation to apply a reduced rate of withholding tax. At any rate, one could understand that this interpretation of the agreement would be in breach of good faith, given the circumstances in which the treaty was negotiated (the application of the capital-import neutrality principle by one of the parties was not a secret). After all, when negotiating a tax treaty, as the history of the Model so clearly indicates, both States may be presumed to have made a mutual examination of the rules of its counterparty, *and found them satisfactory*[1155]. Such a treaty was negotiated on the assumption that the State of residence would grant a full exemption to the treaty claimant regardless of the rules of the treaty. If the State of source knew this, then it is more or less clear that the agreement was not meant to contend with effective double taxation in the first place. If a decision was made to enter into such a treaty anyway, one cannot but assume that the States had an ulterior motivation, a broader purpose, when assuming the commitment imposed by the treaty.

Effective taxation is not needed for the Model to operate because the meaning of 'liable to tax' is simply not 'taxed'. If effective double taxation is not required for a treaty to operate under the description of the subject entitled to claim its benefits, this strongly suggests that the avoidance of double taxation is not the ultimate object and purpose the OECD MC pursues, but only one of the many underlying purposes behind its text. The fact that double taxation does not constitute a condition for the Model to operate clearly suggests that the avoidance of *non-taxation* does not form part of those fundamental concerns the Model is aimed at tackling. This would only occur, as the Commentaries so neatly explain, if the States decide to make an exception to the *absolute obligation to provide exemption*, that is, if they decide to deviate from the policy objectives an agreement such as the Model aims at implementing. If that were in fact the case, one may reasonably be led to conclude, in good faith, that the use of an agreement such as the Model would be restricted to cases of effective double taxation only and, logically, one may also conclude that this is its primary purpose. This, however, is not the case of the OECD MC as a model tax convention as it stands today.

Tax treaties do not have a unique object and purpose. The OECD has been quite cautious when stating what the object and purpose of the Model is, and the reasons for this are no different than those explaining why the context of the Model often seems to be confusing. Just as the context needs to be broad enough to secure the adoption of the OECD MC as a model treaty, so must be its object and purpose.

If the OECD stated that the object and purpose of the Model is limited to the avoidance of effective double taxation, and that its application is meaningless in cases of non-taxation, a number of States, such as those applying capital-import neutrality or territorial taxation, would simply refrain from using the proposed provisions. This is why the OECD does not recommend the subject-to-tax approach. On the contrary, the OECD secures the widespread adoption of its Model by stating that the "*principal* purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons"[1156]. Other than the fruit of trepidation, the OECD has actively fed an ambiguous interpretation of the purpose of the Model, providing one that it is so broad that any State may identify its own hopes and expectations in it.

All these ideas explain some of the many difficulties in attributing its ordinary meaning to a crucial expression such as 'liable to tax'. After all, one cannot ignore the fact that raising the fundamental question of who is entitled to the benefits of a tax treaty indirectly addresses the

1155 FC/WP2(56)1, at p.7.

1156 This clarification was introduced in 2003, see Sec. 7 of Comm. on Art.1. OECD Model Convention.

question of why the States enter into tax treaties. There is no clearer way of manifesting the object and purpose of an agreement than to describe the person who is suffering the *problem* the agreement is supposedly meant to tackle. Under the rules of the OECD MC, the subject entitled to tax treaties is not necessarily a person who is suffering the *evils* of double taxation, and thus one may hardly argue that the overall purpose of an agreement based on the OECD MC is the avoidance of that particular problem. The Model's ultimate purpose, under the influence of the definition of residence, would be to set an allocation of tax jurisdiction, where double taxation is relieved if it occurs, but where the benefits laid down in it are not conditional upon effective double taxation being even potential. On the contrary, they must be granted even if the State of residence applies the territorial principle of taxation, or where it follows the capital-import neutrality principle, cases in which the risk of double taxation is quite insignificant.

In summation, an honest, fair and reasonable interpretation of the term 'liable to tax', in good faith, taking into consideration the history of the Model; the many elements the OECD has used to describe the expression; the context in which the term has been used; and particularly the policy objectives sought by the OECD when deciding to use it, leads to the conclusion that the term 'liable to tax' illustrates nothing more than a connection of authority based on a personal allegiance between the treaty claimant and the State in which treaty benefits are claimed.

In very simple and straightforward terms, this seems to be the only way to include all the possible forms of tax liability around the world, because this is the manner in which residence should be defined to secure the widespread adoption of the Model. It is perhaps fair to conclude that the many questions related to the application of Art.4 OECD MC do not necessarily derive from the use of the term 'liable to tax', but rather from the manner in which the Model has been structured around it. At the outset, it seems that these problems would affect the interpretation of the Model even if the term 'resident' were left undefined, which suggests that eliminating the definition of residence, or changing it for a simpler version, would not necessarily solve these issues. If the term 'resident' were left undefined, there would indeed be less interpretative issues compared to the situation of having to attribute its ordinary meaning to the term 'liable to tax'. Yet this would not guarantee a coherent interpretation of tax treaties. The root of the problem is certainly deeper, and it lies in the policy considerations embedded at the heart of an instrument such as the OECD MC as a model treaty.

13.1.3. Policy issues in relation to the definition of residence and, in particular, connected with the definition of abuse from the perspective of the subject entitled to tax treaty benefits

i) Chapter 10: What kind of policy considerations are involved in the definition of residence in the Model? Is the definition of residence relevant for the purposes of defining treaty abuse? How does the meaning of residence in Art.4 OECD MC inform the meaning of treaty abuse under the rules of the Model?

The balance between residence and source is the keystone of income tax treaties, and the *evilness* of treaty abuse derives, from a policy perspective, from the possibility of altering such a fundamental equilibrium in a shallow, artificial manner. According to the conclusions arrived at in Chapter 10, the inability of the definition of residence to protect this balance, however, should not be striking.

The work done by the League of Nations and, at a later stage, by the OECD, was substantial. That work nevertheless focused primarily in setting out a broad scope of application for tax treaties. According to its history, Art.4 OECD MC was based on the idea that that residence was a domestic issue, and thus no standards were actually needed for domestic residents to access the Model.

Although remnants of that premise are still present in the Commentaries, it is fairly evident that the rise of treaty abuse as an international concern in the early 1960's, and the actions taken by the OECD to confront this problem changed this. The new interpretation of Art.4 OECD MC promoted in 1992 and 2008 clearly sought to establish standards for domestic residents to access the Model, because the definition of residence was too broad, and therefore incapable of impeding the use of its benefits in cases of treaty shopping and profit shifting, which were allegedly *improper.* There were more than enough reasons, however, for the OECD to decide to use this rule for that purpose.

Historically, the OECD chose to use the expression 'resident' over the term 'fiscal domicile' to establish a more flexible scope of application of the Model. The use of the term was due to the need to *provide access* to treaties. Nonetheless, the rise of the issue of treaty abuse imposed the need to look at the definition from the contrary perspective. The definition, which needed to be broad, was too broad, and certain persons, such as conduit companies, had to be left outside its scope. This is, in essence, the fundamental change of paradigm that has been brought up by the OECD nowadays in the context of the BEPS initiative, more than fifty years after the issue was raised for the first time.

A proper rule of tax treaty entitlement should not only have the ability to describe the cases in which the benefits of a treaty may seem desirable, but it should also, and perhaps more importantly, create filters for tax treaty access. This is what the OECD has tried to do when interpreting Art.4 OECD so as to exclude from the scope of the Model conduit companies. However, as has been stated repeatedly across this study, the definition of residence cannot do that. The intentionally broad scope for the application of the Model, which is the vehicle for its consolidation as a model treaty, stands on the way of this interpretation. Courts, scholars and even the OECD have struggled to justify the exclusion of conduit companies (or more generically, taxpayers implementing strategies of base erosion and profit shifting) on the basis of the current rules for almost half a century. Yet it is one thing to suggest that the definition of residence should operate in a way in which certain claims are excluded from the Model, and quite another thing to sustain that the rule has the necessary elements to take the interpretation of treaties to a point where these claims may effectively and doubtlessly be left outside its scope.

Under the policy embedded in the Model, the definition of residence cannot discriminate treaty claims that are shallow or artificial. When answering the question of whether tax treaty benefits are *inappropriate*, *improper*, or *unduly obtained*, the interpreter cannot forget the manner in which the Model has been construed. Absent any other particular provision, such as a limitation-on-benefits rule or a general anti-abuse provision (the effect of which is described in the following section), the reasonableness of treaty benefits needs to be measured according to the standards imposed by the definition of residence. In other words, absent any further rules, in good faith, the boundaries for a definition of tax treaty abuse are set out by what the laws of the State of residence define as proper. This aspect of the definition of residence is commonly overlooked, and yet it is fundamental when seeking to confront such a fundamental issue.

From a more concrete perspective, when trying to understand the failure of the OECD's strategy to contend with treaty abuse by steady expanding the Commentaries, one cannot ignore the fact that the OECD has chosen the wrong path from a series of angles. Firstly, it has defined abuse as the absence of 'comprehensive' tax liability, which under the Commentaries occurs when a person is tax-exempt on all its foreign income, or as an effect of the application of the treaty tie-breaker. This path is undermined by the rules of the Model itself. On the one hand, 'comprehensive' tax liability means nothing more than tax liability on the basis of personal attributes. It is beyond a doubt that, for instance, a conduit company's tax liability is based on an attachment that is strictly personal, even if part of its income is tax-exempt. Moreover, it is also evident that a person having lost a tie-breaker will remain submitted to the tax authority of that State on the basis of personal attributes, and it will not necessarily be treated as a non-resident as a consequence of that (except if this is the path followed by the laws of that State). The anti-abuse approach implemented by the OECD somewhat requires the State losing the tie-breaker to assume that the dual residence scenario was driven by a tax avoidance motivation, which is something that essentially depends on the particular circumstances.

On the other hand, the approach is inefficient because effective taxation is in no way a requirement for treaty entitlement to arise. If a person whose entire income is tax-exempt may be considered to be a resident, then this should logically imply that a person whose income is *partially* exempt (foreign income) must be considered to be a resident as well. The core of the issue of abuse is given by the absence of a real economic nexus between the treaty claimant and the State in which treaty benefits are claimed, resulting in treaty benefits not being justified. Taxation or the lack of it, however, is not. The rules of the Model are utterly unable to confront the particular nature of the issue of treaty abuse (namely the absence of a true economic relation between the treaty claimant and the State of residence) as tax liability, in essence, represents more a political than an economic allegiance.

It is the Model itself that creates the problem of how to determine the existence of abuse. In other words, the fundamental question one really needs to raise when confronting this issue, is what the meaning of *appropriate* or *inappropriate* treaty entitlement is, on the basis of the policy considerations embedded by the OECD in its model treaty. It cannot be assumed that there are certain minimum standards that are capable of excluding conduit companies and other *undesirable* treaty claimants. From the perspective of the definition of residence, contrary to what is commonly assumed and argued, there are no treaty benefits that are universally and indisputably *unintended.* Given the definition of residence in the OECD MC, it is possible to sustain that the existence of abuse is in fact "in the eye of the beholder"[1157]. After all, "just as the law is distinct from the intention of its authors, so must be the determination of the abuse of that law. What follows from this, it is submitted, is that even tax planning designed to avoid a tax treatment that is contemplated by the legislation could nevertheless reasonably be considered to be legitimate in certain circumstances – or, at least, not abusive."[1158]. Arguably, the definition of residence should be interpreted in order to fulfil its original purpose, which is to provide access to treaties, while the issue of abuse should be tackled through different and separate rules. As a matter of fact, if one isolates the many elements through which the OECD has sought to promote the anti-abuse interpretation of Art.4 OECD MC, most of the issues derived from the conceptualisation of the term 'resident' tend to disappear.

Lastly, and objectively speaking, *the need to eliminate obstacles for cross-border trade and investment* is a perfect illustration of a purpose that is meant to say as little as possible in relation to the cases in which treaty benefits cannot or should not be availed of. It is therefore also stated that the lack of clarity as to the object and purpose of the Model is sensibly relevant for the purposes of describing the obscure boundaries of abuse as well. It is only under such a broad formula that no State is really excluded from ever using it, not even States which do not impose an income tax in certain cases, such as the UAE, or States which have explicitly promoted treaty shopping as a tax policy, as India. This is, nonetheless, how the success of the OECD MC as a model tax convention at a worldwide level becomes a reality.

[1157] Blessing, supra note 925, at p.254.
[1158] Nikolakakis, supra note 852, at pp.356-357.

j) Chapter 11: BEPS and treaty residence: Did BEPS change the meaning of tax liability for treaty purposes?

As was stated before, the OECD has attempted to solve the deficiencies of the definition of residence by proposing the addition to the Model of a general anti-avoidance rule and a limitation-on-benefits provision. These new rules are only likely to cause an effect in treaties based on the new version of the OECD MC[1159], and they solve only part of the problem, as stated in Chapter 11. The use of the Model in the context of treaty shopping will be severely restricted, and the excessive broadness of the definition of residence will be successfully tackled. The requirement of a 'qualified person' under the LOB rule, and the necessity to demonstrate that obtaining treaty benefits was not the *principal purpose* of any arrangements entered into with the view of establishing residence will, without a doubt, reduce the propensity to grant treaty benefits in many cases, redefining what *unintended* treaty benefits are in the context of the Model.

The pragmatic approach followed by the OECD has nonetheless ignored some fundamental issues. For instance, the situation of individuals has been completely unattended, although individuals certainly design strategies to abuse tax treaties (as in the *Pavarotti* case). Although tax-exempt pension funds, charities, and educational institutions are treated as qualified persons under the new rules, their tax liability has not been discussed at all. Yet to be a 'qualified person' under the LOB rule, one needs to be a resident under Art.4 OECD MC first. Thus one may easily conclude that, absent any clarification as to the tax liability of these entities, they will continue to have problems when trying to make use of tax treaty benefits. This issue should not have been left unattended. One can expect, therefore, that the interpretative problems surrounding the definition of residence in their respect will not be over.

On the other hand, the GAAR proposed in 2015 focuses mostly on the items of income in relation to which protection is invoked, and not on the characterisation of the treaty claimant as a subject legitimately entitled to treaty benefits. Despite the fact that the rule actually considers the artificial establishment of residence, acting as a *de facto* test in order to put a remedy to the broadness of the definition of Art.4 OECD MC, this result is achieved without changing the meaning of the term 'liable to tax', at the core of it.

Although the presence of a general anti-abuse rule and a limitation-on-benefits provision are a most welcome upgrade for a re-definition of what abusive treaty entitlement means in the *new* context of the OECD MC (after BEPS), reinforcing the definition of residence and thus shrinking the Model's personal scope, this does not mean that the issues of interpretation derived from the definition of residence are essentially solved. The problems related to the definition of residence are much broader, and they are clearly not restricted to conduit structures and the treaty shopping associated with them. Treaty abuse is, in fact, not a problem of *interpretation* of the Model, but it lies at the heart of it, far beyond its rules, in the conflicting policy underlying its provisions. The rule of residence in the OECD MC sends the wrong message in terms of policy, and that, in many cases, prevents one from questioning tax treaty entitlement from the perspective of its pertinence.

[1159] Unless a particular treaty is renegotiated, or if the OECD succeeds in promoting an international instrument on BEPS, capable of modifying all existing tax treaties between its signatories. The OECD has in fact chosen to follow this path to implement the measures agreed in the context of the BEPS initiative, see OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties. Action 15: 2015 Final Report*, (Paris: loose-leaf, October 2015), at pp.18-23.

13.1.4. Questions derived from the potential existence of residence in more than one State, and with the manner in which the OECD MC has dealt with this conflict

k) Chapter 12: How does Art.4 OECD MC deal with the situation of a person who is 'liable to tax' in more than one State? What is the effect of applying the residence tie-breaker?

Bearing in mind the fact that tax liability, and therefore residence, is defined under the laws of the State of residence, a person may naturally maintain such a nexus with more than one State. When this occurs, and more than one State claims the right to tax the same person on the basis of residence, the Model breaks the tie by giving preference to one claim over the other.

The tie-breaker, explored in detail in Chapter 12, is supposed to contain a definition of residence at the treaty level (to break ties), and therefore the relevant tests must be attributed their meaning under international law. There would be no point in defining the tests under the laws of each of the States, for the purpose of the test is to break the tie *as indisputably as possible*. Any disagreements as to the meaning of the term 'permanent home', for instance, at the domestic level, would threaten the purpose of the rule: To define residence in order to break ties.

In the case of individuals, the tie is broken through a hierarchy of tests. In the case of persons other than individuals, the tie has traditionally been broken by using the place of effective management, despite the disgraceful background in which the test was added to the Model in 1957. The 2015 update to the tie-breaker for entities, proposed in the context of the BEPS initiative, has nonetheless modified this test significantly. Under the new version of the rule, the entity tie-breaker must be solved through MAP between the contracting parties. If the States do not reach an agreement, then the dual resident entity is excluded only from the *benefits* of the Model, namely relief or exemption, and not from its characterisation as a resident for other treaty purposes (such as the application of other treaty rules which require the presence of a resident, as in the case of Art.10 and Art.15 OECD MC).

In order to facilitate the agreement of the parties, the new test combines several aspects that are seemingly relevant in the case of an entity, such as the place of incorporation and the place of effective management. In that context, it is perhaps relevant to highlight that, although the need to modify the tie-breaker for entities arose from the many issues the use of the place of effective management caused, this test nevertheless survived in the Commentaries. As a matter of fact, it appears that the test will be fundamental when breaking ties on the basis of the Model's new rules. This should not be striking, however, because under the description of the issue of profit shifting by the OECD (and although highly debatable), effective management is presented *as a synonym* of relevant substance.

The alleged effect of successfully applying the tie-breaker (either when the test is applied unilaterally, as in the old version of the Model, or once the States have reached an agreement in the case of entities under the updated version), is perhaps the most remarkable feature of the provision. In 2008 the OECD promoted an interpretation of the Model according to which residents of States losing a tie-breaker need to be treated as non-residents for the purposes of other treaties. As was stated before, this interpretation has been associated to the second sentence of Art.4(1) OECD MC, on the excuse that these persons should not be subject to 'comprehensive' tax liability, once the tests have been applied.

One must nevertheless keep in mind that the definition of residence applies 'for the purposes of *this* Convention', namely, in the context of the Model *only*, and not necessarily at the domestic level or for the purposes of other treaties. The OECD MC does not have in itself the authority to modify the domestic rules dealing with residence, unless of course those laws recognise that effect. Despite the fact that some States, such as the Netherlands, have followed this interpretation, this solution is very much debatable. Other States have opted for a simpler solution, and they have modified their laws to align them with this result, such as in the UK and Canada. This seems to be the most convenient way of avoiding policy debates and problems of interpretation, because even the OECD has accepted the fact that the Model alone does not have the authority to exclude these persons from the definition of residence domestically.

It may also be relevant to highlight that the effect of applying the tie-breaker (namely the exclusion of the person having lost it) has traditionally been sustained on the necessity of countering treaty abuse. In that context, it may be fair to wonder what it is that makes the situation of a resident of a State losing a tie-breaker abusive. Perhaps the reason for this lies in the fact that a dual residence situation may purposely be created with the express intention of causing a certain result, i.e., with the view of breaking the tie in favour of a given State in order to avoid taxes, as in the *Pavarotti* case. This, however, does not seem to imply that the situation of every dual resident may in itself be abusive, and therefore the anti-avoidance motivation needs to be demonstrated. Considering all these apprehensions, it would not be strange if the tendency to ignore the rules contained in Art.4(2) and (3) OECD MC, and to replace them with a generic rule denying treaty entitlement in cases of dual residence, evolves into a common practice.

13.2. Final words and recommendations

13.2.1. Residence and the role of tax treaties in the XXI century: Reinforcing the equilibrium between residence and source?

Along with many other fundamental questions, the rise of the issue of treaty abuse has awakened many people into thinking that it is perhaps the manner in which the world of taxation is structured, contemplated to be as global as possible, that creates the problem. When looking at the heart of the Model, that is, at the criteria it contains for the allocation of tax jurisdiction, one cannot help but wonder whether residence is in fact suitable in this world. For instance, the fact that taxes had to be imposed on entities (and not on their members) was a decision made historically, to optimise the manner in which tax systems operated. Yet there is a reality today, which is that the interposition of an *alter ego* enables one to avoid taxes.

Historically, residence served as a valid mechanism to overcome the difficulties and threats posed by this phenomenon called double taxation, but this is just history. Nowadays, every few years someone raises his voice to question whether residence is in fact nothing more than another mechanism to avoid taxes. This is intimately connected with the manner in which economies operate. What may be referred to as a 'person' these days does not even need to exist. Moreover, entities may carry out businesses in States without being present therein and, perhaps more fundamentally, they operate on a multinational basis, and tax systems continue to look at this issue from a domestic perspective.

The BEPS project has taken care of some of the issues related to the definition of residence. The provisions dealing with it have been reinforced in a way in which the system of entitlement of the Model is able to discriminate, to some extent, treaty claims that are inappropriate from a policy perspective. Yet the fundamental character of the definition of residence, and the fact that it leaves the impression that whatever that is acceptable under domestic law is also acceptable from the perspective of tax treaties, undermines the concept of a clear and uniform policy from the perspective of the Model itself. This, at the same time, hampers its mission which is to attack some distortions to cross-border trade and investment.

All these speculations inevitably lead, again, to the question of whether residence is in itself an acceptable criterion for the allocation of tax jurisdiction:

> "If such tests are only signals, the primary question is not what test should be applied, but what should it be a test of? What characteristic of a company should be the basis for income taxation on the residence principle? That question naturally leads to another: what is the purpose of taxing corporations?[1160]

The decision to use residence as a criterion for tax treaty entitlement, just as it happened with fiscal domicile before that, was only a decision caused by the needs of that time. These days, things have changed significantly. Residence is indeed a shallow concept, too easy to manipulate. Scholars have dedicated significant efforts to try to find a solution to this lack of equilibrium between residence and source.

The TAG Group and Vann, for instance, have agreed on using elements traditionally linked to source taxation, bringing residence closer to the parameters used for permanent establishments[1161]. Van Weeghel, on the other hand, has proposed an approach based on incorporation but reinforced by a strong anti-abuse provision[1162]. Vogel, for instance, has questioned the need to build tax rules on the basis of residence and source[1163]; van Raad has proposed a very clever model of fractional taxation in replacement of residence and source taxation[1164]; Graetz has suggested that a combination of factors, such as sales, assets, and activities of a taxpayer in a certain State could set out the main threshold for taxation[1165]; Avi-Jonah has proposed a test not based on physical presence, but on a minimum amount of sales in a given State[1166]; and Sadiq has proposed a unitary regime, disregarding the distinction between residence and source[1167]. Couzin, moreover, has suggested considering the redefinition of source, and the redefinition of the relationship between companies and their shareholders[1168]. These are but examples of authors making a real effort to think of a system that is stronger, more reliable, and less vulnerable than the balance between residence and source today. Yet as Vogel observed in 1998, these ideas are very briefly discussed, and then quickly forgotten[1169].

Today, mechanisms are being designed for the re-distribution of income in a world in which income distribution is awful, and some States have turned to their tax systems in order to find an answer to this problem[1170]. However, it appears that those intentions are being undermined by the presence of tax treaties. The lack of balance between domestic and international investment is just an example of this. An entity can be structured internationally in order to restrict or to

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1160 Couzin, supra note 20, at p.264.
1161 Vann, supra note 41; OECD, *The impact of the communications revolution*, supra note 1117.
1162 Van Weeghel, supra note 1097, at p.307.
1163 "It has been taken for granted much too long that income taxes should be based on residence [...] and in addition, on source", Vogel, Klaus, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part 1)', 16 *Intertax* 8/9 (1988), at p.216
1164 Van Raad, Kees, 'Non-Residents - Personal Allowances, deduction of personal expenses and tax rates', in 2 *World Tax Journal* 2 (2010).
1165 Graetz, supra note 155, at p.1417. Graetz explains, at p.1421, that this at the same time eliminates the need for the permanent establishment concept.
1166 Avi-Jonah, Reuven,'Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State', in 113 *Harvard Law Review* 1573 (2000), at p.1671.
1167 Sadiq, supra note 162, at p.190.
1168 Couzin, supra note 20, at p.269.
1169 Vogel, supra note 1163, at p.216.
1170 Chile, which is an OECD member since 2010, introduced a massive tax reform in 2014, which was meant to confront the issue of income inequality and wealth concentration. The changes introduced include a general anti-avoidance provision.

eliminate its tax burdens, and this is not only legal, but it is far from being abusive. That, however, cannot be done in an exclusively domestic setting. Small taxpayers therefore have the disadvantage of *having to pay taxes*, and this creates a comparative advantage for multinational taxpayers. It is not clear whether this may continue to be as it is, without generating additional significant reactions at the social level.

It appears, as Allison Christians has so cleverly explained, that this world needs to understand that there are certain duties that supersede the boundaries of domestic attributions, duties that require commitment at a *higher* level. The benefits derived from the participation in an international community, such as the world of today, impose the need to look at the instruments designed to rule the relation between States as a second-level social contract[1171]. The keystone of this further step in the theory of Rousseau, published in 1762, is the definition of the subject entitled to those agreements[1172]. The OECD needs to realise that the network of treaties based on its Model provides a unique opportunity to lead the world to true *better policies*, insofar as the right standards are imposed, coherent with what the world needs today. Although it is reasonable to think that the States will react to any measure which aims at the direction of affecting their tax sovereignty, it is also a reality that changes will occur any way or the other, and the capability of guiding the States to materialise those changes is a privilege and responsibility only the OECD has.

It is the fundamental mission of the OECD to create and impose the standards this society needs, that tax treaties need and, if a decision were to be made to maintain the distinction between residence and source, it is also its mission to look at the definition of residence and to structure it in a way in which the balance between residence and source cannot be artificially shifted. Base erosion and profit shifting is just an example of global discontent with the abusive use of the law, which is very unlikely to disappear. This is a world where the problem of double taxation is no longer as relevant as the issue of double non-taxation and treaty abuse. People are tired of the manner in which the law operates to favour behaviour as profit shifting. *Tax shaming*, although highly successful in gathering international attention and triggering an immediate reaction, does not seem to be the most appropriate way of generating the changes the global tax system needs in these days.

13.2.2. Contributing to a coherent interpretation of tax treaties from a policy perspective

The question of what to do to solve the issues largely described across the length of this study leads to a regrettable answer. Sadly, the Commentaries to the Model have been taken to such a level of complexity from a policy point of view, that the first thing the States should do when entering into tax treaties is to limit the effect of that inconsistent policy on their own treaties. In a way, this could be done by inserting reservations to the relevant articles, but the problem goes well beyond that. The States should take measures to clarify what their position is from a policy point of view when drafting their agreement, and this could be effected, for instance, in their protocol. Regardless of the particular manner in which they do so, this appears to be the only way

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1171 This is at the heart of the observations raised in the very interesting work of Allison Christians, see supra note 85.

1172 It is relevant to underpin that the OECD has repeatedly had the opportunity to deal with the issue of tax treaty entitlement, and yet, each time a proposal is raised of narrowing the definition of residence, it is rejected. The reasons for this are diverse, see for instance in the field of harmful tax practices, OECD, *Restricting the entitlement to treaty benefits*, (Paris: loose-leaf, 2002), at p.10, were the OECD stated: "During its work, the Committee discussed the extent to which one possible approach to dealing with the issues described above might be through a narrowing of the concept of residence in Article 4 of the Model Tax Convention. In concluded that it would not be appropriate to make changes to Article 4 or the Commentary on that Article because: - to do so could *damage the position of persons who are legitimately entitled*; and – other more effective approaches could be pursued to prevent treaty benefits claims by entities associated with regimes constituting harmful tax competition" (emphasis added).

of avoiding inconsistent interpretations of the rule of residence, leading to situations of perceived abuse in the application of treaties.

Cases of treaty shopping, base erosion and profit shifting, double non-taxation, and many others, cannot simply be excluded from the application of tax treaties by referring to the policy objectives embedded by the OECD in its *Model* as a means of interpretation, because this is actually contrary to what the OECD pursues by elaborating this Model. In a way, a clarification by the States of what the purpose is behind their particular position would save a lot of time for tax authorities and courts, when later explaining or making decisions on the pertinence of benefits derived from treaties based on the Model.

The inclusion of a limitation-on-benefits provision and a general anti-avoidance rule in tax treaties is, once more, by all means helpful when setting out the field for a decision on tax treaty entitlement. Conduit companies and the treaty policy necessary to exclude those arrangements from the application of the Model need the presence of these rules under the current context. Although it is certain that these additions take care of the definition of residence being too broad, one needs to keep in mind the necessity of having a proper correlation between the norms of the treaty, and the policy considerations at the heart of it, as was stated before.

The definition of residence being too narrow, however, deserves further attention. Even if it is true that the LOB provision stipulates that non-profit organisations may enjoy the status of 'qualified persons', it is not any less true that such status is based on their foregoing characterisation as residents of a contracting State. Regardless of the many arguments presented in this work to explain that effective taxation is in no way a requirement for treaty benefits, the tax treaty entitlement of a non-profit organisation is not clear because there is no certainty as to whether they may be treated as residents under the current definition. If it is the wish of the States to eliminate any doubts in respect to their ability to access tax treaties, these clarifications should be explicitly mentioned, just as in the case of the State and its political subdivisions, in the text of Art.4 OECD MC.

Lastly, and summarising all of the different aspects that have been covered by the different sections of this work, one may argue that there is a need to look at tax treaties, and more precisely at the model convention proposed by the OECD from a more comprehensive perspective. It needs to be accepted that there are aspects of the definition of residence which are quite relevant for the purpose of interpreting tax treaties, and thereby for their application, which are not going to be solved. One of those unresolved questions refers to the role of residence in the sphere of treaties, and the manner in which this provision sets out, for better or worse, the fundamental policy consideration behind such an agreement. Allegedly, the most significant challenges the 21st century has brought refer to the role of treaties in the current economic environment. There is much to say from the perspective of the definition of residence in Art.4 OECD MC in that respect.

14. Summary

The benefits of tax treaties are generally available to persons who may be qualified as 'residents' of one or both of the Contracting States. When seeking to interpret and apply a treaty, it is therefore fundamental to understand the meaning of the expression. In fact, absent any other rules on tax treaty entitlement, such as a general anti-abuse rule or a limitation-on-benefits provision, it is this expression which sets out, for better or worse, the personal scope of tax treaties, and thus the situations in which the recognition of benefits contained within become relevant.

The interpretation of the term 'resident' in tax treaties, however, is highly controversial. More often than not, the characterisation of certain treaty claimants such as tax-exempt pension funds, charities or transparent entities as residents is doubtful, and their treaty entitlement becomes debatable. In some of these cases, the definition seems to be too narrow. On the other hand, there are cases in which the excessive broadness of the definition results in the characterisation of conduit companies and other seemingly abusive structures as 'residents' for tax treaty purposes, despite the efforts by the OECD to interpret the rule in a different manner. The elucidation of the meaning of the term 'resident' is therefore essential when the debate as to the appropriateness of tax treaty benefits is confronted.

The present study aims to cast light on the interpretation of tax treaties by attributing its ordinary meaning to the term 'resident of a Contracting State' in Art.4 of the OECD Model Convention on Income and Capital, in good faith, according to the general rule of interpretation under public international law. Moreover, it seeks to analyse and discuss the manner in which the definition of residence contributes to the determination of the object and purpose of tax treaties, and to what extent this definition informs the meaning of abuse from a tax treaty perspective.

One of the main contributions of the present research is connected with the methodology employed. On the one hand, the term ´resident´ is analysed as used in tax treaties, and in the light of the instruments published by the OECD for their interpretation. This implies that the analysis contained in the present study may be of relevance for the interpretation of any tax treaty. On the other hand, the examination of all the different layers of the term ´resident´ results in a comprehensive analysis of the different aspects of the definition, which is also relevant for treaty interpretation purposes. Further, regardless of the value one attributes to historical sources, the profound attention paid to the history of the Model contributes to the understanding of some of the issues surrounding the rule, and to the policy considerations the drafters of the OECD MC sought to embed therein. Perhaps the main contribution of the present research lies in the detailed discussion of the policy considerations behind the determination of the subject entitled to tax treaties, at times in which certain tax treaty claims have been labelled as *inappropriate*, and the recognition of treaty benefits as *unintended*.

15. Samenvatting (Dutch Summary)

Het Begrip Inwoner Onder Belastingverdragen

De voordelen van een belastingverdrag komen in de regel enkel toe aan personen die als "inwoner" in de zin van art. 4 van het OESO-Modelverdrag kunnen worden aangemerkt. Bij het ontbreken van een specifiekere toegangsbepaling, zoals een algemene anti-misbruikregel of een zgn. "limitation-on-benefits"- bepaling, bepaalt het begrip "inwoner" het toepassingsbereik van een belastingverdrag. Vanwege de belangrijke poortwachtersfunctie die het begrip "inwoner" daarmee speelt, is het van groot belang om de uitleg en toepassing van het begrip "inwoner" goed te begrijpen.

De "juiste" uitleg van het begrip inwoner wordt echter vaak betwist. Aan de ene kant is de toekenning van verdragsvoordelen aan vrijgestelde pensionfondsen, goede doelen of transparante entiteiten discutabel, omdat dergelijke lichamen niet zonder meer als inwoner kunnen worden gekarakteriseerd. In enkele van deze gevallen zou kunnen worden gezegd dat de uitleg van het begrip inwoner te eng wordt opgevat. Aan de andere kant zijn er gevallen waarin het begrip inwoner juist te breed wordt uitgelegd. Het kan voorkomen dat brievenbusmaatschappijen en andere aan "misbruik" verwante structuren als verdragsinwoner worden aangemerkt, en daarom verdragsvoordelen genieten. Dit ondanks het feit dat de door de OESO voorgestane interpretatie van het begrip inwoner het verdragsinwonerschap aan dergelijke entiteiten ontzegt. De uitleg van de term "inwoner" is daarom van essentieel belang voor de vraag op welke voordelen belastingverdragen eigenlijk zien.

Dit onderzoek heeft als doel de uitleg van het begrip inwoner te verhelderen in het licht van het algemene volkenrechtelijke uitleggingsvoorschrift zoals uiteengezet in artikelen 31 en 32 van het Weens Verdragenverdrag. Daarnaast analyseert dit onderzoek op welke manier de definitie van inwonerschap bijdraagt aan de bepaling van het voorwerp en doel van belastingverdagen. Deze vaststelling heeft op haar beurt invloed op hoe moet worden omgegaan met belastingverdragen in misbruiksituaties.

Eén van de voornaamste bijdragen van dit onderzoek is de manier waarop de uitleg van het begrip inwoner is benaderd. Enerzijds is het begrip geanalyseerd in het licht van zijn gebruik onder belastingverdragen en in de door de OESO gehanteerde interpretatiebronnen. Anderzijds biedt het onderzoek een diepgaand inzicht in de theoretische achtergrond van het inwonersbegrip. Om die reden is dit onderzoek van belang voor de uitleg en toepassing van belastingverdragen wereldwijd. Daarenboven is er veel aandacht besteed aan de geschiedenis van de regel en beleidsmatige overwegingen die de vervaardigers van het OESO-Modelverdrag hanteerden bij de totstandkoming van dat Model. Dit boek biedt daarmee een uitgebreide uiteenzetting van de beleidsmatige achtergrond van de toekenning van de verdragsvoordelen in een tijd waarin de toekenning van dergelijke voordelen ter discussie staat.

16. List of Abbreviations* **

AAR	Authority for Advanced Rulings, India
CFA	Committee of Fiscal Affairs
Comm	Commentaries to the OECD Model Convention
FC	Fiscal Committee
GAAR	General anti-abuse rule(s)
LOB	Limitation-on-benefits
LON	League of Nations
OEEC	Organisation for European Economic Cooperation
OECD	Organisation for Economic Cooperation and Development
OECD MC	OECD Model Convention
POEM	Place of effective management
TAG GROUP	Technical advisory group on monitoring the application of existing treaty norms for the taxation of business profits
UNCLT	United Nations Convention on the Law of Treaties
VCLT	Vienna Convention on the Law of Treaties
VCDR	Vienna Convention on Diplomatic Relations
WP1	Working Party 1 of the OECD
WP2	Working Party 2 of the OECD
WP5	Working Party 5 of the OECD
WP6	Working Party 6 of the OECD
WP12	Working Party 12 of the OECD
WP14	Working Party 14 of the OECD
WP28	Working Party 28 of the OECD
YBILC	Yearbook of the International Law Commission

* In the case of historical documents by the League of Nations, the United Nations, the Organisation for Economic Cooperation and Development (OEEC – OECD), a list of abbreviations has been provided in the list of reference materials.

** The OEEC, 'Organisation for European Economic Cooperation', was the predecessor of the 'Organisation for Economic Cooperation and Development' (OECD), until 1961. Accordingly, all references made to the OEEC indicate events occurred before 1961, while references made to the OECD correspond to events that occurred during and after that year.

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18. Curriculum Vitae

Francisco obtained his law degree at Universidad de Talca, Chile, and later on his Masters in Taxation at the Faculty of Economics of the same university. After graduating from the Advanced LLM in International Tax Law at the International Tax Center, Leiden University, he started his PhD in International Tax Law at the Law Faculty of Leiden University, the Netherlands.

In the academic field, he is a visiting lecturer at the International Tax Center Leiden, and at the Executive International Tax Law Program of the ITC Leiden in Panama City. He has taught International Taxation, Tax Planning, and Stock Market Taxation at the Masters in Tax Direction and Planning, and at the MBA of the Faculty of Economics, Universidad de Talca, Chile.

In addition to his academic background, he has an extensive experience working as a legal and a tax advisor for domestic and international clients. His areas of interest are mostly connected with cross-border operations, interpretation and application of tax treaties, anti-abuse rules, and tax litigation.